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Opportunistic Behavior and the Law of Contracts

Timothy J. Muris*

I. INTRODUCTION

Much of contract and commercial law focuses upon whether a contract exists, the meaning of an agreement's terms, and the consequences of a breach.¹ Besides addressing these fundamental questions of formation, interpretation, and remedy, courts often police an array of business actions undertaken in performance of the contract. A major problem occurs when a performing party behaves contrary to the other party's understanding of their contract, but not necessarily contrary to the agreement's explicit terms, leading to a transfer of wealth from the other party to the performer—a phenomenon that has come to be known as opportunistic behavior.² Because of the wealth transfer, parties have an incentive to avoid becoming

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1. The most detailed and famous treatment of these areas of the law is the multi-volume treatise A. CORBIN, CORBIN ON CONTRACTS (2d ed. 1962).

2. See O. WILLIAMSON, MARKETS AND HIERARCHIES: ANALYSIS AND ANTI-TRUST IMPLICATIONS (1975); Klein, *Transaction Cost Determinants of "Unfair" Contractual Arrangements*, 70 AM. ECON. REV. 356 (1980); Klein, Crawford & Alchian, *Vertical Integration, Appropriable Rents, and the Competitive Contracting Process*, 21 J.L. & ECON. 97 (1978); Klein & Leffler, *Market Enforcement of Contracts: The Role of Price in Guaranteeing Quality*, 00 J. Pol. Econ. 000 (forthcoming); Williamson, *Transaction Cost Economics: The Governance of Contractual Relations*, 22 J.L. & ECON. 233 (1979); Williamson, Wachter & Harris, *Understanding the Employment Relation: The Analysis of Idiosyncratic Exchange*, 6 BELL J. ECON. 250 (1975).

victims of opportunism, yet whatever strategy of self-protection they choose, deterrence will be costly.³ Thus, for a given amount of opportunism avoided, an individual will choose the least costly method or combination of protective methods.

This Article examines how certain legal principles—implicit terms of contracts—can be low-cost methods of deterring opportunistic behavior. These legal principles or doctrines have arisen when courts attempted to police contractual performance with general concepts such as good faith⁴ and with a variety of more specific doctrines that apply to particular types of transactions. The general concepts remain ill-defined, however, and the foundation or purpose of the more particular doctrines appears uncertain. Although these doctrines are traditionally viewed as diverse, this Article demonstrates that many of them are unified by an underlying principle that provides a firmer basis for the doctrines than is normally given—the deterrence of opportunism. The language of judicial decisions varies, but many courts have acted to deter opportunism and hence to decrease its costs.

Part II of this Article more precisely examines the nature of opportunistic behavior and considers alternative solutions to the opportunism problem, emphasizing the adoption of legal principles that become implicit terms to a contract unless the parties expressly stipulate otherwise. Part III surveys several areas of contract and commercial law, in which the transaction which provokes litigation involves possible opportunistic behavior. Because opportunistic behavior is clearly unlawful when it is easily detectable, the analysis emphasizes behavior that is ambiguous in character or that is difficult to detect even after it occurs.

II. OPPORTUNISM: ITS NATURE AND ALTERNATIVE DETERRENTS

A. THE NATURE OF OPPORTUNISTIC BEHAVIOR

Two examples illustrate the opportunism problem. First, consider a two-year contract in which a construction company hires an architect for \$3,000 a month.⁵ After the architect has

3. For example, parties could insist upon contractual clauses forbidding specific opportunistic acts or they could painstakingly investigate the reliability of each party with whom they plan to deal.

4. See note 79 *infra* and accompanying text.

5. *Lingenfelder v. Wainwright Brewing Co.*, 103 Mo. 578, 15 S.W. 844 (1891), suggests these facts.

become thoroughly familiar with the details of the project, he informs the construction company that the project will only be finished for \$4,000 per month. Putting aside for the moment whether a court will enforce the increase, the construction company will agree to the architect's demand if it cannot hire a suitable replacement or take some other action, such as not finishing the project, at less than \$4,000. Because architects may not be available on short notice or because of the original architect's specialized knowledge of and relationship to the project, the contractor may have to pay a new architect a larger fee than \$4,000 per month, especially if it takes the new person time to "get up to speed." Provided the construction company cannot find a suitable replacement at \$3,000 or less, the original architect will be able to obtain a salary increase up to the difference between \$3,000 and the next best substitute.

Consider also a successful fast-food franchisor. Its trademark is a valuable commodity, representing to consumers a specific standard of quality on such attributes as food, service, and cleanliness. Maintaining the value of the trademark requires franchisee expenditures on these attributes. If consumers frequently patronize various franchises of the same franchisor, an individual franchisee has the incentive to avoid expenditures on quality because the franchisee will, at least for a time, continue to attract consumers who expect and are willing to pay for higher quality.⁶ The lower-quality franchisee will benefit by the full amount of the savings from reducing quality maintenance, but will lose only part of the cost. Thus, the lower-quality outlet will benefit at the expense of the franchisor, the higher-quality franchisees, and consumers.

These two examples suggest the conditions under which opportunism occurs. To begin with, the problem occurs after the contract is formed; it is not a problem of precontractual monopoly. The existence of a competitive market for architects and franchisees prior to formation of the contract would not necessarily have prevented the problem. Further, the victim of the opportunistic behavior must place some value on the contractual performance that the opportunist can appropriate. If another architect were available post contract at \$3,000 or if consumers did not value the franchisor's trademark, no incen-

6. Theoretically, consumers need frequent only one franchise. If the franchisee who reduces quality will receive a competitive rate of return in future employment, he has an incentive to lower quality to obtain a higher than competitive return even if the franchisee receives no repeat business.

tive for opportunism would exist.⁷ Finally, the victim must have failed to plan for the opportunistic behavior, perhaps naively so. If the victim had done otherwise, the victim would have avoided the problem so long as the costs of prevention were less than the expected costs of the opportunism.⁸

The architect and franchisee illustrations also reveal that the threat of opportunism increases transaction costs because potential opportunists and victims expend resources perpetrating and protecting against opportunism. For example, a franchisor wary of opportunism may investigate prospective franchisees more carefully, make the franchise contract more detailed, and engage in extensive monitoring. On the other hand, the franchisee may expend resources to make the nature of the cheating more difficult to detect. Resources spent to implement or prevent opportunistic behavior do not help produce a commodity or service that the contracting parties mutually value. Accordingly, the elimination or reduction of these expenditures will improve the wealth of society by freeing the resources for productive use.⁹ The challenge for the law is to help reduce these costs without imposing still higher costs in the process.

This challenge is complicated because some forms of opportunism are more easily detected than others. If the architect knows that obvious opportunistic behavior will result in an unenforceable modification, he or she may engage in more sub-

7. The value that creates the incentive to act opportunistically has been characterized as an "appropriable quasi rent." See Klien, Crawford & Alchian, *supra* note 2, at 298-302. For example, if the construction company needed to pay \$4,000 a month to replace the architect's services, there would be an appropriable value of \$1,000. The appropriable value does not exist unless the specific identity of the contracting parties influences costs. This "economics of idiosyncrasy" is discussed at length in Williamson, *supra* note 2, at 238-45, and in Williamson, Wachter & Harris, *supra* note 2, at 251.

8. Even if potential victims frequently anticipate opportunism, thereby reducing the amount of actual opportunism, a role for judicial prohibition of such behavior still exists. See notes 16-21 *infra* and accompanying text. Although guile has been discussed as a form of opportunistic behavior, see O. WILLIAMSON, *supra* note 2, at 9, 26-30, whether or not such behavior has "moral" overtones is relevant only to the extent that social mores against such behavior will reduce the amount of it. The important point for this Article is that when opportunistic behavior increases profits, people have an incentive to engage in it.

9. For a discussion of these costly activities and their impact on society's welfare, see Clarkson, Miller & Muris, *Liquidated Damages v. Penalties: Sense or Nonsense?*, 1978 WIS. L. REV. 351, 371-72; Landa, *An Exchange Economy with Legally Binding Contract: A Public Choice Approach*, 10 J. ECON. ISSUES 905, 911-17 (1976). That social gains result from reducing expenditures aimed solely at transferring wealth is now widely accepted in legal and in economic literature. See, e.g., Clarkson, Miller & Muris, *supra*, at 370; Landa, *supra*, at 915-17.

the activities, such as claiming that unanticipated conditions on the work site require more time and effort and hence justify a higher fee. If the law enforces modifications for unanticipated circumstances or for other reasons, distinguishing opportunistic behavior from valid modifications may be difficult. Similarly, the franchisee might reduce quality in ways that are difficult to detect. For example, the franchisee could decrease the monitoring of employees, thus discouraging the provision of proper service, or could reduce the portions of food served below the amounts that consumers have come to expect. Although these activities are sometimes detectable, their systematic detection may be costly. Moreover, although the franchisor may think that the franchisee has violated a specific clause designed to insure higher quality, if the franchisee has been careful, litigation to prove a breach would be costly and its result uncertain. This Article refers to such opportunism as subtle opportunism. In general, opportunistic behavior is subtle in two ways: first, the behavior is inherently difficult to detect; second, although the activity is detectable, it is easily masked as legitimate conduct, and thus its opportunistic nature is discoverable only at a high cost.

Consideration of two other issues will facilitate the analysis required to formulate principles against subtle opportunism. First, the concepts of opportunism and breach should be distinguished. Although opportunism provides a basis for condemning as a breach certain conduct that does not violate explicit contractual language, not all breaches involve opportunism. For example, one party may gain sufficiently from the breach to compensate the nonbreacher for any losses and still benefit. Without a wealth-transfer, no opportunism exists although a breach still occurs. In addition, when exogenous circumstances render performance within the terms of the contract impossible, a breach exists, but opportunism does not.¹⁰ Nonperformance in such situations may harm both parties as, for example, when they desire to complete the contract but a government regulation forbids it. Further, when one party has an honest but unreasonable understanding of the performance it agreed to render, actual performance becomes a breach. Here, the breach is a misunderstanding, not an attempt to transfer wealth to the breaching party.

A second necessary distinction in forming legal principles against opportunism involves the role of the wealth transfer

10. Of course, the law may excuse such a breach.

from the victim to the opportunist. Any condemnation of opportunism based simply on this wealth transfer would first require that the victim be legally entitled to the wealth it loses. Placement of the entitlement is, after all, the issue at hand. The wealth transfer is significant not because of its mere existence, but because the transferring act itself does not produce a beneficial product nor promote the productive goal of the contract; yet both perpetrating and protecting against such a transfer are costly. Returning to the architect example, the court's decision to permit or to prohibit the modification clearly changes the wealth of the parties; the architect's gain depends upon the legal rule. Although the goal of the contract—in this case, construction—will be fulfilled under either rule,¹¹ both parties will incur transaction costs if the contract is modified to pay the higher price. Because there is merely a wealth transfer that does not influence fulfillment of the contract's goal, the courts can choose the legal rule that minimizes the parties' costs of negotiating, performing under, and enforcing their contract. Rules prohibiting opportunism are preferable to rules permitting opportunism, therefore, if the former more effectively reduce transaction costs. However, before concluding what may seem obvious—that prohibiting opportunism reduces its costs—the alternative efforts that potential victims may use to deter opportunism must be carefully considered.

B. NON-CONTRACT LAW SOLUTIONS TO THE OPPORTUNISM PROBLEM

The existing literature emphasizes four methods by which potential victims can reduce, or even eliminate, opportunism.¹²

11. See note 9 *supra* and accompanying text; note 91 *infra*. For the sake of illustration, the text ignores the possibility that the costs of opportunism can be so high as to discourage some exchange of wealth. For a discussion of this possibility, see note 19 *infra* and accompanying text. Even if exchanges are not discouraged, opportunism could be condemned if it raises the costs of exchange. Thus the possibility of decreased exchanges strengthens the case against opportunism.

12. No attempt will be made at a rigorous comparison of the utility of the solutions discussed. For more rigorous comparisons of the noncontract law solutions, see the sources cited in note 2 *supra*. Nevertheless, these sources pay insufficient attention to the law's role in deterring opportunism. For example, some authors are aware of the importance of detection costs, but nevertheless ignore its relevance for deterrence through law. See Klein, Crawford & Alchian, *supra* note 2, at 301, 309 & 320. Thus, they imply that even without changed circumstances an individual under a legally enforceable contract could successfully request and receive a higher price. *Id.* at 308. Williamson discusses how parties choose different "governance structures" for their relationship. For example, the architect's contract could leave dispute settlement to the govern-

First, if good reputation has importance to the potential opportunist, the risk of a bad reputation may deter some acts of opportunism. For example, the architect may desire the future business of construction companies that would learn of the untimely demand for a salary increase. Second, the potential victim may adjust the price to alleviate the cost of anticipated opportunism or to deter its occurrence. Thus an employee who is expected to cheat by shirking an average of one hour a day can be paid a reduced wage to reflect the expected shirking.¹³ In the franchise example, the franchisor may allow the franchisee to earn more than a competitive rate-of-return, giving the franchisee more to risk from being caught at cheating than from having a lower return. Third, in some cases, the potential victim might avoid the risk of opportunism by choosing to own the desired product, a practice known as vertical integration. For instance, home owners may buy rather than lease land beneath their property to prevent landlords from increasing the rent up to the cost of moving their homes elsewhere. Finally, the parties can write a contract that precisely specifies the performance to be rendered, such as a franchise contract that includes detailed specifications of quality, relying on the courts to enforce the explicit provisions.

Each of these methods, however, will fail to deter opportunism in some situations. For example, reputation provides little deterrent when potential opportunists can conceal their actions from those with whom they expect to contract. Vertical integration is of limited value because it often costs more than alternative forms of doing business, and because one cannot own performance by humans in the sense that one can own property such as the land in the home owner illustration. Thus, even if the construction company in our first example had hired the architect as an employee rather than as an independent contractor, the architect might still command a higher wage because of the architect's special knowledge of the job. Fully explicit contracts, in which a court's role is only to enforce the contract as written, are not feasible when the cost of discovering and planning for all possible contingencies is prohibitive. Further, breach of some terms will be difficult to detect and

ance structure of commercial and contract law or to a different structure such as arbitration. See Williamson, *supra* note 2, at 246-54. Williamson does not, however, discuss whether doctrines within the law can reduce the incentive to behave opportunistically.

13. Because it is anticipated, the shirking that then occurs is not opportunistic.

even if detected, difficult to prove to an external observer such as a court. This problem is especially serious with subtle opportunism.

Price adjustments also can fail to deter opportunism satisfactorily. For example, even when an employer could hire more employees at lower wages to solve the problem of shirking, a greater quantity of lower quality labor at a low price may not perfectly substitute for a smaller quantity of more expensive, higher quality labor. Thus, a firm may find that hiring additional managers is not a reasonable solution to the problem of managerial shirking.¹⁴ Additionally, the "last-period" problem plagues both price reductions to compensate for opportunism and price increases to deter opportunism. If the relationship between the two parties has a known end point in time (*i.e.*, a last-period), then a price adjustment will not necessarily prevent opportunism. If, for example, the architect's salary were reduced below \$3,000, the architect could still expropriate the difference between that salary and the price of the construction company's next best alternative. In the franchise case, even the franchisee who is receiving an above-the-market return may reduce quality once he or she knows the franchise relationship is about to end.

This last-period problem is particularly important for specific doctrines of contract law because many of the cases that come before the courts involve relationships in which the parties appear unlikely to contract with each other in the future. Indeed, one would expect more litigation in last-period situations, particularly when the opportunist has a chance of winning the case (as with subtle opportunism). Because litigation will ordinarily decrease the probability of future business with the victim, one who expects no future business is more likely to risk the litigation that often accompanies opportunistic acts.¹⁵

14. In an extreme example of the failure of price adjustments to solve the opportunism problem, a baker may lower quality by adding sawdust to the flour. To at least some consumers, a greater quantity of bread with sawdust is not a perfect substitute for less bread without, even if the lower quality bread is much cheaper. Of course, even when price reductions are effective, potential victims may use other measures to compliment the reduction. In the employee situation, the employer may use some combination of monitoring workers and adjusting wages based on anticipated output.

15. For a discussion of the last-period problem and its solutions, see Klein, Crawford & Alchian, *supra* note 2, at 304 n.17. One additional role for the law concerns cases in which the price-increase solution creates a possibility of the potential victim becoming a potential opportunist.

C. CONTRACT LAW SOLUTIONS TO THE OPPORTUNISM PROBLEM

A fifth category of deterrents to opportunism involves developing legal principles that become implicit terms to any contract unless the parties expressly stipulate otherwise. For example, courts could determine that modifications obtained in circumstances like the architect example are illegal unless the original contract provided otherwise. If potential victims find these implicit terms useful, they can sometimes avoid complicated contractual language. In other words, implicit terms increase reliance on relatively simple contracts. The usefulness of implicit terms depends in part upon the ineffectiveness of other methods of deterring opportunism. Nevertheless, even when other methods of solving the opportunism problem are unsatisfactory, the usefulness of implicit terms will be reduced to the extent that reliance upon them requires a costly lawsuit with uncertain results.

The effectiveness of implicit judicial terms will depend significantly upon how precisely courts define rules for dealing with opportunism. Courts could, for example, apply a general rule that opportunism is unlawful, leaving the details of defining opportunism to a case-by-case approach. At the other extreme, courts could attempt to deter opportunism through precise rules geared to specific transactions, such as a rule that enforces modifications only with new consideration.¹⁶ Costs and benefits, both in the amount of opportunism deterred and in costs to the parties and the courts, affect the attractiveness of any approach. These costs and benefits have been dealt with elsewhere,¹⁷ however, and this Article will discuss them in detail only as they apply to several specific legal doctrines.

Some general comments, however, will indicate the significance of precision in rulemaking. Although greater precision reduces costs, such as the litigation expenses of the parties, precision also can deter some desired behavior while allowing some undesired behavior. For example, rigid enforcement of

16. See notes 22, 36, 37 *infra* and accompanying text.

17. See, e.g., Ehrlich & Posner, *An Economic Analysis of Legal Rulemaking*, 3 J. LEGAL STUD. 257, 262-71 (1974). Precision can only be measured with reference to the party addressed. *Id.* at 271. Thus, courts and parties may differ in their view of a rule's precision. For additional discussions of economic aspects of the procedural system, see Posner, *An Economic Approach to Legal Procedure and Judicial Administration*, 2 J. LEGAL STUD. 399 (1973) (discussing that the economic goal of the system is to minimize the sum of the costs of making errors and the litigation costs of the parties and the courts); Schwartz & Tullock, *The Cost of the Legal System*, 4 J. LEGAL STUD. 75 (1975) (clarifying the costs of violations).

the consideration rule for modifications will prevent some modifications in which opportunism did not occur, but permit some in which it did. Nonetheless, the less precise, case-by-case approach to rulemaking has an inherent, substantial disadvantage when subtle opportunism is involved. Because of the nature of subtle opportunism and of the judicial process, the trier of fact will have great difficulty ascertaining the presence of opportunism. Even when one expends resources to determine that he was a victim, additional costs would arise to convince an external observer such as a court, especially when the opportunist is claiming otherwise. For example, a court may easily determine that a modification in fact occurred, but, particularly if the opportunist has been careful, the court may have difficulty in determining whether the modification was opportunistic. Allowing both parties to present evidence without restriction is costly and is not necessarily helpful in correctly deciding the case, especially if the disagreement focuses on whose "word" is more credible. To reduce this problem, rules could be developed to focus on the existence of objectively verifiable circumstances that act as surrogates for the existence of opportunism. Although these surrogates need not be conclusive, they would at least be useful in allocating burdens of proof.¹⁸

Because potential victims will insist on an adjustment in the price or other terms of the contract to offset the costs of deterring opportunism, the value of judicial rules against opportunism becomes clear. When the courts satisfactorily resolve the precision problem to develop an implicit term that deters opportunism more cheaply than other methods, benefits to both parties exist as of the time the contract is signed.¹⁹ This is not

18. The development of objective surrogates only guides—not eliminates—the role of the jury. Without objective surrogates, the jury's evaluation of subjective intention would be costly without necessarily improving the quality of decisions enough to justify the costs. For another treatment of the difficulties facing the fact-finder, *see generally* R. DANZIG, *THE CAPABILITY PROBLEM IN CONTRACT LAW* (1978).

19. The most basic doctrine in the law of contracts provides a simple illustration. For hundreds of years, English and American courts have allowed a contract to create legally enforceable rights when parties have exchanged promises of future performances. If parties could breach without legal consequence, opportunistic behavior would be encouraged, but many voluntary exchanges of promises of future performance would continue. If parties could not rely on the courts, they would instead rely on credit bureaus, bonding, experience gained from past dealings, and other such devices to reduce uncertainty and to protect against the consequences of nonperformance. Such a system appears more costly than court enforcement of promises, however, because credit bureaus and bonding increase the cost of contracts, including those that are made by (at the least) increasing the number of agreements necessary to

to say that potential victims will necessarily rely on contract law more often than on other methods.²⁰ Parties do often resolve disputes without resorting to courts or even to legal rights,²¹ presumably because they find contract law more costly, for the benefits received, than the nonlegal solutions available. Nevertheless, assuming that parties choose the best options available for deterring opportunism, knowledge of contract law is crucial to understanding how parties respond to the possibility of opportunistic behavior. In short, the law of contracts affects people's ability to act opportunistically. How this ability in turn affects contract law is the subject of the remainder of this Article.

achieve a given objective. Thus even though these contracts are made, it will often be less costly to allow court enforcement of the original agreement. Moreover, in some cases, these increased contractual costs would cause total costs to outweigh the benefits of contracting, thereby decreasing the number of exchanges. For further discussion of the problems without legal enforcement, see R. POSNER, *ECONOMIC ANALYSIS OF LAW* 66-67 (2d ed. 1977), and Landa, *supra* note 9, at 911-16.

Deterring opportunism also explains why the relief for breach should include any wealth transfer between the parties as well as the extra resources the non-breacher reasonably spends to find a substitute. For example, if *B* contracts to buy goods from *S* for \$10 and the market later drops to \$8, a damage award which includes the two dollar price differential discourages *B* from breaching simply because he would gain two dollars from *S* at the expense to both *B* and *S* of making a second contract.

20. Three additional points are relevant regarding the cost minimizing impact of rules reducing opportunism. First, because parties do not pay all of the costs of courtrooms, judges, and court employees, the possibility exists that potential victims will rely too much on implicit terms. Because one reason for not having parties pay all of these costs is that otherwise courts would create a less-than-optimal amount of rules—such as those to deter opportunism—one cannot conclude that this possibility in fact is a reality. See Landes & Posner, *Adjudication as a Private Good*, 8 J. LEGAL STUD. 235, 240-42 (1979). Second, minimizing costs may also reduce benefits and thus require analysis of the net effect. See generally notes 22-78, 145-56 *infra* and accompanying text. Finally, rules avoiding opportunistic behavior comprise only a subset of cost-minimizing rules. See generally Priest, *Breach and Remedy for the Tender of Nonconforming Goods Under the Uniform Commercial Code: An Economic Approach*, 91 HARV. L. REV. 960 (1978).

21. See, e.g., Macaulay, *Non-Contractual Relations in Business: A Preliminary Study*, 28 AM. SOC. REV. 55, 60-62 (1963). The existence of methods to deter opportunism does not mean that opportunism will never occur. When the potential victim is fully protected at the time the contract is formed, there will not be opportunism. Full protection, however, is unlikely to be universal. For example, the potential victim may have poorer knowledge of the methods of appropriation than the other party. Even with use of deterrence methods such as a higher price, this lack of knowledge will lead to the existence of opportunism. See Klein, Crawford & Alchian, *supra* note 2, at 305. In addition, uncertainty may exist over whether courts will condemn certain behavior.

III. CONTRACT LAW AND SUBTLE OPPORTUNISTIC BEHAVIOR

We begin with examples of easily detected acts in which the existence of opportunism is difficult to determine: modifications, good faith in performance (which in turn is divided into examples focusing on specific acts), and nonconforming tenders. The discussion next turns to franchising, a problem involving the subtle nature of the examples first discussed in this section as well as opportunistic acts whose very existence is difficult to detect. Finally, stipulated damage clauses are analyzed; the major opportunism problem with respect to these clauses concerns inability to detect the act at all. Besides subtlety, these examples share three distinct characteristics. First, they involve problems of behavior after contract formation. Second, important parts of the law usually applied to these examples have generally been regarded as troublesome or even incomprehensible. Finally, the law will be seen to have a heretofore unperceived coherence: in effect, courts imply a term to deter opportunism.

A. MODIFICATIONS

Hundreds of appellate court cases have involved a modification that has increased the duties of one party under the contract without increasing that party's rights. Our architect example illustrates this recurring pattern: the company must pay a higher price to the architect, but the architect promises to do only what previously had been promised. For this reason, in the jargon of contract law, these modifications are said to lack consideration.²² Understanding the subtle nature of these modifications is important to distinguishing opportunistic from nonopportunistic modifications in principle and in practice.

1. *Subtlety*

As seen in the architect hypothetical, modification cases can involve opportunistic behavior. Common examples include

22. RESTATEMENT (SECOND) OF CONTRACTS § 75 (1)-(2) (Tent. Draft No. 7, 1973) provides: "(1) To constitute consideration, a performance or a return promise must be bargained for. (2) A performance or return promise is bargained for if it is sought by the promisor in exchange for his promise and is given by the promisee in exchange for that promise."

Most of the examples in this Article involve possible extortion by the performing, as opposed to the paying, party. This is for convenience only; both parties can extort if conditions such as those discussed in text accompanying notes 5-9 *supra* exist.

the extortionist, who will not perform without more favorable terms, and the debtor who will repay only at a lower price, often manufacturing a "dispute" to justify the difference.²³ Because many modifications are beneficial, however, we could not simply bar all of those that lack consideration. For example, circumstances sometimes change from those the parties thought existed when they signed the original contract. A leading case, *Watkins & Son v. Carrig*,²⁴ involved a contract to excavate a cellar. Soon after excavation started, the excavator hit solid rock, and the parties then agreed that the excavator would receive a nine-fold price increase.²⁵ Several reasons unrelated to opportunism may explain why the owner of the property agreed to pay a higher price. For instance, the owner might gain a reputation for fair dealing, avoid driving the excavator into bankruptcy, prevent the excavator from giving poorer-than-normal performance, or feel enhanced self-esteem from acting altruistically.²⁶ Thus, both the owner and the exca-

23. See J. WHITE & R. SUMMERS, UNIFORM COMMERCIAL CODE 46-48 (2d ed. 1980). The best discussion of the case law of modifications, at least as of the early 1960's, is 1 A. CORBIN, *supra* note 1, at §§ 171-192. For a good discussion of more recent cases, particularly under the Uniform Commercial Code, see Hillman, *Policing Contract Modification Under the UCC: Good Faith and the Doctrine of Economic Duress*, 64 IOWA L. REV. 849, 862-76 (1979). For leading case examples of extortion, see *Alaska Packers' Ass'n v. Domenico*, 117 F. 99 (9th Cir. 1902) (owing to remoteness of place and shortness of season, fishermen who stopped work were promised additional compensation to finish job of catching and canning salmon); *Hackley v. Headley*, 45 Mich. 569, 8 N.W. 511 (1881) (plaintiff in need of money accepted \$4,000 on a take-it-or-sue-me basis from the defendant who owed at least \$4,260); *Lingenfelder v. Wainwright Brewing Co.*, 103 Mo. 578, 15 S.W. 844 (1891) (an architect engaged in building a brewery, who stopped work because a contract for a refrigerating plant had been awarded to business rival, was promised a commission of five percent of the cost of the refrigerating plant as inducement to resume work). For cases involving modifications of loan agreements in which a creditor who appeared to be in a precarious position allowed the debtor to request and receive more favorable terms than under the original contract, see Havighurst, *Considerations, Ethics and Administration*, 42 COLUM. L. REV. 1, 28 n.76 (1942).

24. 91 N.H. 459, 21 A.2d 591 (1941).

25. *Id.* at 460, 21 A.2d at 591.

26. Acting to prevent a poor quality performance is itself an effort to avoid a type of opportunism. On the other motivations for accepting a modification without new consideration, see Posner, *Gratuitous Promises in Economics and Law*, 6 J. LEGAL STUD. 411, 421-25 (1977). As Posner suggests, *Goebel v. Linn*, 47 Mich. 495, 11 N.W. 284 (1882), was arguably a good example of attempting to prevent a company from going broke. Posner, *supra* at 421. In *Goebel*, an ice company agreed to supply all of the ice required by a brewer for not more than two dollars a ton. Part way through the contract, the ice company informed the brewer that, because the ice "crop" had failed the previous winter, it would no longer ship ice at the contract price. The parties then agreed to a modification at \$3.50 per ton. Professor Dalzell, however, contends that there is no evidence to support the argument that keeping the ice company in business explained

vator benefit from the modified price. As another example, a merchant with a note due for \$6,000 may value \$5,000 received today much more than \$6,000 at a later date because of an opportunity to invest the money at a high return. Accordingly, the merchant may be willing to accept \$5,000 as a complete discharge if the debtor is financially troubled and cannot pay the \$6,000 when due.²⁷

Thus, the mere existence of a modification does not establish whether it was mutually beneficial or extorted. Because only some modifications are extorted, they present a source of subtle opportunistic behavior. If one assumes that neither extorted nor mutually beneficial modifications are empirically trivial in litigated cases, a per se rule toward modifications is inappropriate.²⁸ Instead, distinguishing extorted from mutually beneficial modifications becomes crucial. If no distinction can be found and applied, at least some parties can be expected to rely on more costly methods to protect themselves, such as drafting detailed clauses to cover otherwise unanticipated circumstances.

2. *Opportunistic or Mutually Beneficial Modifications: Distinguishing in Principle*

In principle, the distinction between opportunistic and nonopportunistic modifications lies in the promisor's reasons for agreeing to the modification. If *A* agrees to a modification with *B* only to avoid the costs of suing *B*, the modification merely transfers wealth from *A* to *B* at the expense both of entering into the agreement and of expending the effort to avoid becoming a victim. In other words, the modification is opportu-

the modification. See Dalzell, *Duress By Economic Pressure I*, 20 N.C. L. REV. 237, 264 (1942). The court found that a gratuitous motivation explained the modification in *Gray v. Barton*, 55 N.Y. 68 (1873) (creditor gave valid gift to debtor of unpaid balance of account). The Depression-era cases in which landlords decreased rent may be examples of owners attempting to maintain their good reputation assuming that the landlords wanted their tenants to continue renting after the termination of their lease. Given the precarious financial position of many of the tenants, landlords may also have benefitted by helping to keep the tenants from bankruptcy. See, e.g., *Liebreich v. Tyler State Bank & Trust Co.*, 100 S.W.2d 152 (Tex. Civ. App. 1936). But see *Levine v. Blumenthal*, 117 N.J.L. 23, 186 A. 457 (1936) (refusing to enforce reduced rental agreement).

27. See *Ebert v. Johns*, 206 Pa. 395, 397, 55 A. 1064, 1064 (1903).

28. This is true unless the costs of using the judicial system dictate otherwise. The question of whether or not most litigated modifications are either extorted or mutually beneficial is ultimately an empirical one. See text accompanying note 52 *infra*. But in the appellate cases in which one can determine the reason for the modification, both types appear to be frequent. See notes 23, 26 *supra*.

nistic or extorted. Even though *A* would win a suit for breach of the original contract, *A* may need immediate performance to avoid serious financial problems. Moreover, the lawsuit may not fully compensate any loss because the victim cannot recover the direct cost of litigation, including attorney's fees, and because some damages occasionally cannot be obtained.²⁹

Having agreed to the extortion, the promisor presumably preferred the modification to then-existing alternatives. Accordingly, nonenforcement of the modification could lead to the promisee's breach, and thus to potential harm to the promisor. A rule deterring extorted modifications would prevent such harm if it "enforced" the modification without giving the promisee the extorted advantage, leaving the promisor with the performance agreed to under the terms of the original contract. This approach creates a problem, however. If promisees know that they cannot gain through modifications, they will prefer breach to performance of the original contract when the benefits of breach exceed the costs. One such case occurs when the promisee is judgment-proof and the promisor agrees to the modification to keep the promisee in business. This modification is mutually beneficial. If, on the other hand, the promisor is faced with a judgment-proof promisee desiring to work elsewhere, the promisor may turn to other legal solutions, such as tort damages for inducing breach of contract against the party with whom the promisee deals, specific performance of the original contract, or an injunction to restrain the promisee from working elsewhere.

29. For example, the doctrines of *Hadley v. Baxendale*, 156 Eng. Rep. 145 (1854), and of certainty limit the ability of the promisor to be fully compensated. These limitations increase the promisor's costs and thus increase the amount that the promisee can extort.

This Article addresses the role of the pre-existing duty rule in deterring opportunism. Common law rules of damages and awards of litigation expenses are accepted as given. A complimentary strategy, beyond the scope of this Article, would be to modify those other rules. Even if those doctrines were improved, however, there would still be a residual category of cases in which the damage remedy is not fully compensatory, creating a value for promisees to appropriate. For example, under the certainty doctrine, there would be cases in which the benefit gained by measuring damages more accurately would not be worth the cost.

When the parties settle an honestly disputed claim, the settlement contains consideration and is not a modification as that term is used in this Article. See, e.g., RESTATEMENT (SECOND) OF CONTRACTS § 76B (Tent. Draft No. 1-7, 1973). If all settlements were enforced, some could be extorted by one party simply asserting an invalid claim and stating "sue me if you do not like my terms." The requirement of an honest dispute, however, appears to prevent this form of opportunism. See *id.*

Of course, promisees could still extort from their promisors the lesser of the costs of a lawsuit or the price of alternative performance. An anti-extortion rule does not prevent promisees from extorting this amount or from breaching and attempting to "bluff" promisors from undertaking lawsuits. A rule does prevent promisees from extracting larger gains at the expense of the promisor, as when some of the promisor's damages are noncompensable and the promisee could otherwise extort the amount of these damages in addition to the litigation expenses. Reducing these larger potential gains reduces the resources used to engage in and deter opportunism.³⁰

Distinguishing in principle between modifications raises other complications. Even when a modification has been mutually beneficial, possible extortion cannot be ignored. For example, a party's discovery that he or she can make a better deal elsewhere is one reason for a modification that is not necessarily mutually beneficial. In *Schwartzreich v. Bauman-Basch, Inc.*,³¹ a company agreed to pay a designer \$90 a week. Two months after the original contract began, the designer was offered \$115 elsewhere. The original company and the designer then agreed on \$100 a week, and the court enforced the modification.³² Although the modification may have been mutually beneficial—for example, the company may have wanted to establish a reputation among its employees for fair dealing or have wanted to keep them happy to avoid poor performance—one cannot preclude extortion simply because someone else offered the designer more than the contract price.³³ The modifi-

30. Two other strategic consequences of the pre-existing duty rule deserve mention. First, when the gains to the promisee from breach exceed the gains from extorting only the litigation costs, the pre-existing duty rule will give the promisee an incentive to breach when the promisor desires performance. See text accompanying note 29 *supra*. Second, because suing after performance is received avoids the problem of noncompensable damages, promisors have an incentive to avoid litigation until the promisee performs under the modification. Of course, promisees would only expose themselves to litigation when there was uncertainty about the law or facts.

31. 231 N.Y. 196, 131 N.E. 887 (1921).

32. *Id.* at 205, 131 N.E. at 890. As is often noted, the stated reason for the result—that the parties agreed to rescind the original contract before entering the modification—is faulty, given that the rescission and the signing of the new contract occurred simultaneously. See, e.g., 1 S. WILLISTON, CONTRACTS 179-80 (3d ed. W. Jaeger 1957).

There were discrepancies between the designer's and the company's versions of the facts. The designer stated that the new offer was for \$110 and that the company initiated the modification. The company argued that it had no choice but to offer more money given the unavailability of substitute performance. 231 N.Y. at 199-200, 131 N.E. at 888.

33. Posner argues that

cation transferred \$10 a week to the designer; if the designer had breached the original contract, he would have had to compensate the company for the damage.³⁴ Thus, the company was worse off under the modification relative to the original contract.³⁵

Moreover, that the modification provided less money than the second offer does not demonstrate that extortion was absent. At the time of modification, the promisee may have felt that the promisor would not sue if the promisee kept the increase to \$10 a week. Alternatively, the promisor may have suspected that the promisee preferred the original job at \$100 because of nonpecuniary benefits. Under this assumption, the promisor, depending upon his or her bargaining skills, could have limited the amount extorted. Thus, although *Schwartzreich* may have been correctly decided, extortion was possible even given a second offer higher than both the price of the original contract and of the modification.

3. *Distinguishing in Practice: The Present State of the Law*

Given the subtle nature of opportunistic modifications, it is not surprising that only some modifications are enforced. The common law refuses to enforce modifications that fall within the pre-existing duty rule. In its simplest form this rule states that when a party agrees to do only what it had already promised, there is no consideration, and the modification is invalid.³⁶ Although the rule could be applied to bar all modifications not supported by consideration, it has never been so rigidly interpreted. Many modifications without consideration have been

[b]ecause the higher price is a genuine opportunity cost of continued compliance with the contract, the promisor should be allowed to terminate subject only to his obligation to make good the promisee's loss from the breach, and hence he should be allowed to negotiate with the promisee over a modification that will compensate the promisor for lost opportunity.

Posner, *supra* note 26, at 424. Nevertheless, although the parties should be allowed to negotiate, the presence of the lost opportunity does not necessarily negate the possibility of extortion.

34. If the company would have had to pay a substitute designer \$115, the damage would be \$25 per week plus the costs of locating the substitute.

35. Because the first contract gave the first company designing services at \$90, the opportunity that the designer lost by not first agreeing with the second company represents a gain to the original company. Rewarding the designer solely for his lost opportunity harms the original company. Moreover, avoiding the expenses of a lawsuit would not have justified the modification. See text accompanying note 29 *supra*.

36. For good summaries, see A. CORBIN, *supra* note 1, § 175; S. WILLISTON, *supra* note 32, § 130, at 443-45.

enforced, particularly when unanticipated circumstances arose that made the change appear mutually beneficial, as in the cellar excavation case.³⁷

Whether or not they enforce the modification, few courts discuss the underlying factual and policy issue, namely, whether the modification was extorted. Many scholars and a few judges, however, have explicitly recognized this as the crucial issue,³⁸ and their arguments have triumphed both in the *Second Restatement of Contracts* and in the Uniform Commercial Code. Although section 76A of the *Second Restatement* retains the pre-existing duty rule, section 89D(a) states that modifications are valid if "fair and equitable in view of circumstances not anticipated by the parties when the contract was

37. On the cases enforcing modifications, see 1 A. CORBIN, *supra* note 1, § 175 n.16. On cases involving unanticipated circumstances, see *id.* § 184; Annot., 85 A.L.R.3d 259 (1978). Of course, if the unanticipated circumstances were such as to discharge the duty, the likelihood of extortion would greatly decrease. The cases reveal, however, that the circumstances do not have to be so severe. See A. CORBIN, *supra* note 1, § 184. See also Annot., 12 A.L.R.2d 78 (1950) (indicating that cases enforcing modifications on the now repudiated rescission theory, see note 32 *supra*, often involve unanticipated circumstances). Concerning the meaning of unanticipated, Comment b to the *Second Restatement* section 89D states:

The reason for modification must rest in circumstances not "anticipated" as part of the context in which the contract was made, but a frustrating event may be unanticipated . . . if it was not adequately covered, even though it was foreseen as a remote possibility.

RESTATEMENT (SECOND) OF CONTRACTS § 89D, Comment b (Tent. Draft No. 1-7, 1973) (emphasis added). Although the question is not free of doubt, it appears that the parties need to have allocated the risk for the circumstances within the course of their negotiations before the circumstances are "anticipated."

Because one can almost always point to some unanticipated event, it is important to emphasize that the new circumstances must be linked to the reason that makes the modification mutually beneficial. For example, in *Barnwell & Hays, Inc. v. Sloan*, 564 F.2d 254 (8th Cir. 1977), a cotton farmer agreed to sell all cotton grown on 200 acres during 1973. Part way through the year, his cotton gin was destroyed and the buyer then agreed to accept only 12 more bales in full satisfaction of the farmer's duty. From these facts it could be argued that the unforeseen circumstances of the destruction of the gin greatly increased the seller's cost of performing beyond the 12 bales and that the buyer benefited from enhancing a reputation for fair dealing or perhaps from helping keep the farmer in business. The farmer, however, proceeded to sell over 60 bales to others at a much higher price than the original contract. Assuming that the original buyer was unaware of the other bales, it appears that the foundation for concluding that the buyer benefited—the seller could not (except perhaps at great cost) furnish more than 12 bales—did not exist. Thus, the modification does not appear properly linked to the unanticipated circumstance. The court nevertheless enforced the modification, *id.* at 256, illustrating the tendency of courts to ignore the extortion issue under the Uniform Commercial Code. See text accompanying note 46 *infra*.

38. For scholarly criticism, see, e.g., 1 A. CORBIN, *supra* note 1, § 183, at 148-49; G. GILMORE, *THE DEATH OF CONTRACTS* 22-28, 76-77 (1974).

made.”³⁹

*Recker v. Gustafson*⁴⁰ illustrates the tendency of common law courts not only to prevent opportunistic modifications, but also to improve in their analysis of such problems. In *Recker*, the original contract provided for the sale of 155 acres for \$290,000. Approximately three weeks after the contract was formed, the sellers' attorney informed the buyers that the sellers “were willing to go to court to get out of the [original] agreement and that litigation was expensive,”⁴¹ whereupon the buyers agreed to the sellers' suggestion to raise the price to \$300,000. In the buyers' suit for specific performance of the original contract, the trial court ruled that the modification was valid. The Iowa Supreme Court reversed, despite precedent in Iowa that arguably supported enforcement of such modifications on the faulty logic that the parties had rescinded the first contract at the same time as the modification.⁴² The *Recker* court rejected this theory. The court's discussion of the *Second Restatement*, however, suggested approval of the results, but not the reasoning, of prior cases that had applied the rescission theory—particularly a trio of cases decided between 1946 and 1955, in which the *Recker* court noted the presence of unantici-

39. RESTATEMENT (SECOND) OF CONTRACTS § 89D(a) (Tent. Draft No. 1-7 (1973)). Section 89D(c) allows enforcement based upon reasonable reliance. Section 76A, Comment a, recognizes extortion as the explicit basis for enforcement. For a recent illustration of the *Second Restatement* approach, specifically adopting section 89D(a) in an unanticipated circumstances case, see *Angel v. Murray*, 113 R.L. 482, 493, 322 A.2d 630, 636 (1974). For other favorable discussions of section 89D, see *Brian Constr. & Dev. Co. v. Brighenti*, 176 Conn. 162, 169, 405 A.2d 72, 76 (1978); *Gintzler v. Melnick*, 116 N.H. 566, 569-70, 364 A.2d 637, 640 (1976). Section 348 of the *Second Restatement* also retains the oft-criticized rule of *Foakes v. Beer*, 9 App. Cas. 605 (1884), holding that modifications for payments of debts need new consideration. See RESTATEMENT (SECOND) OF CONTRACTS § 348 (Tent. Draft No. 13, 1978).

In contrast to the *Second Restatement*, the *Restatement* in section 76(a), adopted the pre-existing duty rule without stating the policy basis and without a section such as 89D. Professor Williston, the reporter of the *Restatement*, defended the pre-existing duty rule as “consistent” with other principles of consideration. S. WILLISTON, *supra* note 32, at 420. A few courts, however, have found that the *Restatement* incorporates the unanticipated circumstances test. See, e.g., *Lange v. United States*, 120 F.2d 886, 890 (4th Cir. 1941); *Evergreen Amusement Corp. v. Milstead*, 206 M.D. 610, 616, 112 A.2d 901, 903 (1955) (citing *Lange* as authority). These courts mistakenly relied on Illustration 8 to section 76 which would only enforce the modification if the new circumstances excused the promisee's duty to perform under the original contract.

40. 279 N.W.2d 744 (Iowa 1979).

41. *Id.* at 747.

42. This theory has a long history, including use in *Schwartzreich v. Bauman-Basch, Inc.*, 231 N.Y. 197, 205, 131 N.E. 887, 890 (1921). See notes 31-35 *supra* and accompanying text.

pated circumstances.⁴³

In contrast to the common law, the Uniform Commercial

43. *Recker v. Gustafson*, 279 N.W.2d 744, 755-59 (1979). The *Recker* court also found section 89D inapplicable to the facts before it, see 279 N.W.2d at 758-59, and although the court did not explicitly approve the results of the earlier cases, it did discuss the *Second Restatement* favorably. Indeed, simply because the court felt it necessary to discuss the applicability of the *Second Restatement*, indicates some judicial recognition of the persuasiveness of the *Second Restatement* position. Nevertheless, Professor Hillman criticizes *Recker* as clinging to the pre-existing duty doctrine in a way that will cause the law of contract modification in Iowa to remain confusing and unpredictable. See Hillman, *Contract Modification in Iowa—Recker v. Gustafson and the Resurrection of the Preexisting Duty Doctrine*, 65 IOWA L. REV. 343, 355-62 (1980). Although Hillman seems to be criticizing the court for mechanical application of the pre-existing duty rule, he does note that the court "intimated that it might follow the *Second Restatement* approach in the future when unanticipated circumstances have led to the modification." *Id.* at 356 n.83. He raises two problems with this result. First, even if Iowa adopted the *Second Restatement*, "after *Recker* Iowa courts apparently would enforce unfair or inequitable modifications if additional consideration flowing to the promisor could be found. At least there is nothing in the opinion that suggests such modifications would not be enforceable." *Id.* Because the court was not faced with the issue of additional consideration, it is difficult to see the basis for this contention. If the court had stated that it would focus solely on the issue of new consideration, Hillman's fears would be justified, but the discussion of the *Second Restatement* provides evidence that the Iowa courts will not so act.

Second, Hillman is critical of the *Second Restatement* position itself. In part, he fears that "unanticipated" has no clear meaning. *Id.* at 357. Although no mechanical test exists, the concept is capable of use and understanding. See note 37 *supra*. Hillman also argues that the *Second Restatement* would preclude enforcement of modifications that are voluntarily made but not the result of unanticipated circumstances. Hillman, *supra*, at 357. For example, he suggests that if the *Recker* evidence revealed that the buyers voluntarily agreed to the \$10,000 price increase because they believed they had struck a very good deal and wanted to maintain good relations with the sellers, then the modification should be enforced. The deal could have appeared to be good at the time of the contract or only at some subsequent period. If it was a good deal subsequently for unanticipated reasons, the modification would be enforceable under the *Second Restatement*. Hillman is correct as to a favorable deal at the time of the contract. Nevertheless, if the buyers knew that they were taking advantage of the sellers at the time of the contract yet wanted to maintain good relations with them, it is not clear why they would not have offered to pay a higher sum in the original contract. Moreover, given that the buyers would now be claiming extortion, in the absence of unanticipated circumstances proof of mutual benefit would be very difficult, leading to higher costs with no certainty of improving the decision. If there are no unanticipated circumstances, it is difficult to see why there is mutual benefit. As Hillman himself admits, "people do not often voluntarily give up something for nothing." *Id.* at 358. Finally, even under the *Second Restatement* rule, the buyers would not be prevented from maintaining good relations with the sellers by, for example, a gift of \$10,000 or even entering into a valid rescission of the contract, and at some later date agreeing to pay \$300,000. In contrast to *Recker*, other recent cases still mechanically apply the pre-existing duty rule in cases in which the modification was probably a product of extortion. See, e.g., *Engle v. Shapert Construction*, 443 F. Supp. 1383, 1387 (M.D. Pa. 1978) (contractor attempt to modify contract held unenforceable).

Code explicitly repeals the pre-existing duty rule.⁴⁴ The comments to section 2-209, however, reveal that modifications must meet the test of "good faith."⁴⁵ Rather than employ this "good faith" requirement as a method of policing extortion, many Code cases have ignored good faith entirely or have given it only perfunctory attention.⁴⁶ Thus, in practice, the Code appears to have worked a result quite different from that of the common law. The Code has failed to provide a mechanism to prevent extorted modifications.

4. *Distinguishing in Practice: The Approach Implicit in the Common Law*

In all of the criticism of the pre-existing duty rule, one issue—an issue that would be important even if the Code did control extortion—has received scant attention.⁴⁷ The issue is how courts should distinguish between illegal and legal modifications made without consideration, given that a per se rule is inappropriate.⁴⁸ An understanding of the different approaches

44. See U.C.C. § 2-209(1).

45. U.C.C. § 2-209(1), Comment 2 states:

The effective use of bad faith to escape performance on the original contract terms is barred, and the extortion of a "modification" without legitimate commercial reason is ineffective as a violation of the duty of good faith. Nor can a mere technical consideration support a modification made in bad faith.

The test of "good faith" between merchants or as against merchants includes "observance of reasonable commercial standards of fair dealing in the trade," [Section 2-103], and may in some situations require an objectively demonstrable reason for seeking a modification.

46. See Hillman, *supra* note 23, at 862-76. See also notes 61-65 *infra* and accompanying text.

47. To some extent, Hillman, *supra* note 23, is an exception, although this Article disagrees with some of his fundamental concepts. See text accompanying notes 73-76 *infra*.

Posner presents an economic approach to modifications, emphasizing the manner in which the promisor might benefit, and also briefly discussing how courts should prevent enforcement of modifications in "monopoly" situations such as *Alaska Packers Ass'n v. Domenico*, 117 F. 99 (9th Cir. 1902). See Posner, *supra* note 26, at 423-24. This Article differs from Posner's approach by analyzing both the transaction cost aspects of opportunistic behavior (extortion in this case) and the evidentiary problems of an optimal rule regarding modifications. A "monopoly" analysis such as Posner's does not capture as well as does an opportunism analysis the problems in the cases to which the pre-existing duty rule applies. For example, when a debtor extorts a poor creditor, the problem is not that the debtor has an ability to reduce output in the usual sense of a monopolist, but rather that, given the creditor's circumstances, a lawsuit is unattractive. See note 23 *supra* and accompanying text. Moreover, the problem is clearly not one of precontractual monopoly. See text accompanying note 7 *supra*.

48. See text accompanying note 28 *supra*.

taken by the common law and by the UCC helps explain the poor performance of courts under the Code.

One problem in distinguishing opportunism from mutually beneficial behavior involves allocating the burden of persuasion.⁴⁹ The burden influences the nature of the trial and the verdict that is reached when the jury cannot otherwise decide whether the modification was extorted. An important issue in allocating the burden concerns the percentage of all modifications that are extorted. If most modifications were mutually beneficial, the burden would best be placed on the party opposing the modification, because cases decided on the basis of this allocation would involve fewer mistakes than would be likely with the opposite allocation.⁵⁰ Yet ascertaining the proportion of modifications that are mutually beneficial is quite difficult. Many scholars seem implicitly to assume that most modifications are valid, even those without consideration.⁵¹ Further, in cases involving continuous dealings, parties face a cost from extorting or from reneging on a modification, such that modifications in this context seem more likely to be valid. Nevertheless, the validity of most litigated modifications cannot be assumed.⁵² Even if most modifications are valid, most of those actually litigated may not be; litigated cases are not necessarily a representative sample of all modifications. In addition, although continuous dealings may provide a disincentive to extort, the fact of litigation indicates that the opportunist does not value the goodwill that usually exists during continuous dealings. Ultimately, determining what percentage of litigated modifications is extorted is an empirical question for which no evidence currently exists.

Even if we knew the percentage of extorted modifications

49. The "burden of persuasion" falls upon the party who will lose on that issue unless the evidence is sufficiently in his favor to meet a given "standard of proof" which in civil cases is usually "more likely than not." See MCCORMICK'S HANDBOOK OF THE LAW OF EVIDENCE § 336, at 784, § 338, at 794 (2d ed. E. Cleary 1972).

50. Thus, if nine out of ten litigated modifications are valid, placing the burden on the party favoring validity will cause a mistake in ninety percent of the cases that are decided solely on the basis of the allocation of the burden of persuasion. The allocation of the burden will influence the type of cases that are litigated, complicating the analysis by requiring knowledge of the total modifications likely to be litigated under alternative assumptions.

51. See, e.g., J. DAWSON, GIFTS AND PROMISES 208-11 (1980).

52. If we knew that finding validity when the clause was invalid caused greater costs than finding invalidity when the clause was in fact valid, this fact would influence our calculus. There appears to be no basis, however, to distinguish between the costs of the two types of error. See Posner, *supra* note 17, at 408.

so as to allocate the burden of persuasion, courts would still face the difficult problem of detecting extortion in individual cases. Resolution of the extortion issue requires an inquiry into whether the modification was mutually beneficial. Because the promisor to the modification, who has received the "short end" of the deal relative to the first contract, will claim extortion in any litigated case, the fact-finder will face conflicting testimony. If a jury attempts to determine directly whether the promisor benefited, it may be forced into a decision based solely on whose "word" is more credible—a subjective and treacherous task.

The modern common law, as implied in the principles of the *Second Restatement*, has in effect reduced this evidentiary problem by taking a predominantly indirect approach to assessing promisor benefit. Under section 89D(a), any enforceable modification requires "an objectively demonstrable reason for seeking" it.⁵³ The usual method for meeting this requirement

53. RESTATEMENT (SECOND) OF CONTRACTS § 89D, Comment b (Tent. Draft No. 1-7, 1973). The modification must be "fair and equitable" in light of the unanticipated circumstances. See text accompanying note 39 *supra*. Although the comments to section 89D do not greatly elaborate on the meaning of "fair and equitable," it appears consistent with the requirement, see note 37 *supra* and accompanying text, that the unanticipated circumstances must be linked to the reason why the modification is mutually beneficial. Further, the "fair and equitable" requirement implies that even with unanticipated circumstances, the promise may have still been extorted. See text accompanying notes 68-70 *infra*.

Although this Article does not agree with *Restatement* sections 76A and 89D(a) in all of their particulars, it does accept them as generally correct statements of the modern common law. Reliance on the Restatements in this manner is not justified as to all sections. See, e.g., note 93 *infra*; Clarkson, Miller & Muris, *supra* note 9, at 354, 381 n.82 & 382-83. Reliance is justified as to sections 76A and 89D(a) because the two central tenants of those sections—that the pre-existing duty rule exists to deter extortion and that unforeseen circumstances are the touchstone for enforcement of modification—are consistent with the majority of common law cases, as revealed by the cases cited here and by the substantial amount of commentary analyzing those cases. See notes 23-26 *supra* and the sources and cases cited in the Reporter's Notes to sections 76A and 89D. This Article does not agree with sections 76A and 89D(a) in all of their particulars, however. For example, the sections do not discuss at all the evidentiary justification for the rules as considered *infra* and Illustration 3 accepts the result in *Schwartzreich* without mentioning the possibility of extorting.

This is not to deny that the refusal of courts to discuss explicitly the extortion issue has led to confusion and occasional decisions inconsistent with the theory proposed here. Some cases enforcing modifications do so without explicitly discussing lack of extortion or the existence of unforeseen circumstances and in so doing do not reveal sufficient facts on these issues to determine whether the decision was correct. Other cases mechanically apply the pre-existing duty rule, searching for any trivial difference to call a new consideration, without giving sufficient facts to determine whether the modification

involves showing unanticipated circumstances. From such circumstances a court can infer mutual benefit, because the promisor has arguably benefited, if at all, because of them. For example, the promisee may have encountered unexpected obstacles, be near bankruptcy, or present some similar fact from which a court can conclude that the promisor has gained from agreeing to the modification even though no new rights are received. The existence or absence of these unanticipated circumstances will normally be objectively verifiable, and will not depend solely on the credibility of the respective parties.⁵⁴

Occasionally, cases involving mutually beneficial modifications will present difficult evidentiary problems or, perhaps, even be denied enforcement. For example, returning to an employee case such as *Schwartzreich v. Bauman-Basch, Inc.*,⁵⁵ the employer may grant a modification when the employee finds his or her immediate supervisor unexpectedly harsh. Even if the employer has this nonextortive reason for increasing the employee's pay, if in the context of litigation the employer changes its mind, the employee's claim of "harshness" presents potentially greater complications than the claim in the construction case of "I hit stone," since "harshness" is a more subjective concept. Nevertheless, the employee can still rely on objective circumstances such as a change in supervisors, a change in other work conditions, or specific events as testified to by fellow employees.⁵⁶

was probably extorted. In any event, given that the parties rarely use litigation to settle their disputes, see generally Macauley, *supra* note 21, and that parties will only litigate when there is some disagreement over the facts or the law, see Landes, *An Economic Analysis of the Courts*, 14 J. L. & ECON. 61, 91 (1971), presumably only "close" cases are litigated. Thus it should not be surprising to find some cases that conflict with others.

Finally, comment 2 to U.C.C. § 2-209, quoted in note 45 *supra*, could have, but has not, formed the basis for interpreting the Code similar to the *Second Restatement*.

54. Analytically, the promisee would have to show both the occurrence of some circumstance and that the circumstance was unanticipated. On the nature of "unanticipated," see note 37 *supra*.

55. 231 N.Y. 196, 131 N.E. 887 (1921). See notes 31-35 *supra* and accompanying text.

56. Besides an inquiry into whether the circumstances that have changed were anticipated, it is possible that opportunism was anticipated. Returning to our architect example, assume that the architect is valued at \$3,000 and that the litigation to avoid an extorted modification cost \$1,000. Opportunism and its consequences can be avoided by a salary of \$2,000, assuming no quality problems, see text accompanying note 14 *supra*, no information problems in determining the correct discount, and no problem of uncompensatory damages. If the architect attempts to hold out for an additional amount greater than \$1,000, he or she can then profitably be sued. In practice, to avoid forcing the court to make the precise determinations of value, a promisee's claim that the price was

At least one other objectively verifiable method exists to demonstrate that the promisor benefited, namely, assessing the alternatives available to the promisor at the time of the modification. Because the modification imposes a new cost upon the promisor relative to the original contract, the issue is whether an alternative was available at less cost than the modification. If so, the promisor presumably chose the modification because its benefit exceeded the higher cost, and the modification should therefore be considered mutually beneficial.⁵⁷ For example, if the architect in our earlier example receives a modification to \$4,000 per month and the construction company could have found a substitute of equal quality for less (including the costs of search and negotiation), the modification appears mutually beneficial. The reasonableness of the alternatives appears to be recognized in the common law of modifications.⁵⁸

Of course, this "reasonable alternative" device probably has somewhat limited application in the modification context. As alternatives to the modification, the promisor can either sue the promisee or seek substitute performance. Litigation will often be more costly than the modification, given the ability of the promisee to increase the promisor's expenses and the failure of the law to provide for compensation of litigation expenses and for certain types of damages. Were litigation to compensate the promisor fully and thus be equal in value to

adjusted to account for opportunism should be limited to more obvious examples.

In general, the argument that because parties will anticipate opportunism if it is legal, rules against opportunism are unnecessary, ignores the potential differences in costs between different rules. See notes 5-21 *supra* and accompanying text; notes 175-77 *infra* and accompanying text.

57. Promisors who claim that they were nevertheless coerced or who were unreasonably ignorant about the alternative should still have their modifications enforced since enforcement will motivate such promisors to protect their own interests when court supervision is unnecessary for that protection.

58. In providing case examples of whether modifications are enforceable, the *Second Restatement* § 89D, illustrations 2 and 5, imply the existence or non-existence of possible lower-cost substitutes as a relevant criterion. See *RESTATEMENT (SECOND) OF CONTRACTS* § 89D (Tent. Draft No. 1-7, 1973). It should be noted that in illustration 2, based upon *Lange v. United States*, 120 F.2d 886 (4th Cir. 1941), the modification was enforced when alternatives were all higher-priced. Unforeseen circumstances existed, however, and the promisee agreed to perform at zero (accounting) profit, thus reducing the likelihood that the modification was extorted. In addition, alternatives are important in the law of duress which is related to the problem discussed here. See *RESTATEMENT (SECOND) OF CONTRACTS* §§ 316-317 (Tent. Draft No. 12, 1977). One problem with the *Second Restatement* treatment of reasonable alternatives in the duress context may exist—insensitivity to the inadequacies of the legal process. See *RESTATEMENT (SECOND) OF CONTRACTS* § 317, Comment b, Illustrations 1-7 (Tent. Draft No. 12, 1977).

performance of the first contract, any modifications entered into would then be necessarily more attractive than the original contract. The market alternative may appear more attractive, but its attractiveness is limited by the costs of finding substitute performance, including the costs of the substitute being inferior. Because the promisor would only be reimbursed for such costs upon successfully suing the promisee—and even then some costs might not be reimbursed as incapable of certain estimation—these costs provide a basis for promisee extortion. Nevertheless, the presence of a less-costly legal or market alternative, with cost including search and other damage costs, is an objectively verifiable circumstance from which to infer a mutually beneficial modification.

Insistence on objective circumstances reduces the number of trials that will turn upon more subjective evidence, such as the jury's attempt to determine promisor benefit directly. If the promisee—the party favoring the modification—cannot show objective reasons for change, the pre-existing duty rule will apply. The focus on objective circumstances eliminates the costs of directly determining promisor benefit, at least in the absence of unanticipated events. The focus also reduces uncertainty, further lowering costs.⁵⁹ Although the commentators and cases are silent on the issue, the common law approach thus appears to allocate the burden of persuasion to the party favoring the modification.⁶⁰ The burden can be met either by showing a lower-cost alternative that the promisor rejected or by showing unanticipated circumstances from which one can conclude that the modification was mutually beneficial.

Contrasting this interpretation of the common law with the UCC position reveals some of the advantages of the former. For example, in *Pirrone v. Monarch Wine Co.*,⁶¹ the evidence was insufficient to meet the promisee's common law burden of

59. For a recent example of a court shortening the trial, see *Mobile Turnkey Hous., Inc. v. Ceafco, Inc.*, 294 Ala. 707, 713, 321 So.2d 186, 191 (1975) (explicitly recognizing that extortion was the crucial issue, the court refused to enforce a modification when circumstances were anticipated, thus precluding difficult issues in future cases of similar circumstances, including determination of whether a modification even existed or was of mutual benefit).

60. An additional reason for allocating the burden of producing evidence to the promisee is that the promisee should usually have more knowledge of the unanticipated circumstances because those circumstances relate to the promisee's reason for nonperformance.

61. 497 F.2d 25 (5th Cir. 1974). For a more detailed discussion, see Hillman, *supra* note 23, at 863-66.

persuasion, but because UCC standards were applied,⁶² the court enforced an apparently extorted modification. Pirrone, a winemaker, agreed to sell to Monarch, America's largest purchaser of peach brandy, 150,000 gallons in 1968 and again in 1969. Apparently because it had overbought brandy and because the market price fell to two-thirds of the contract price, Monarch unsuccessfully attempted to negotiate a quantity reduction and then breached the shipping schedule. In 1969, with Pirrone complaining of financial difficulty, its facilities loaded with brandy, its production of the more profitable wine limited, and its ability to ship in Monarch's control because of the necessity for Monarch to initiate a shipping permit, the parties agreed to a modification terminating Pirrone's rights for the 1969 sale. Although Pirrone received damages for breaches occurring before the modification, the Court of Appeals for the Fifth Circuit reversed a jury award of lost profits for the 1969 sale.⁶³ The court noted that the modification did not need consideration, and briefly dismissed Pirrone's claim of duress.⁶⁴ The result would have been different if the court had applied the burden of persuasion rule suggested above. Given the apparent absence both of unanticipated circumstances that could have led to a mutually beneficial modification and of any lower-cost alternative for Pirrone, the modification would not have been enforced, thereby preventing extortion.⁶⁵

If the promisee did meet the burden of persuasion as proposed above, what result would follow? The existence of a low-cost alternative would render the modification valid⁶⁶—prom-

62. Many courts have refused to police modifications for extortion despite the Code's good faith test. See text accompanying note 46 *supra*.

63. 497 F.2d at 29.

64. *Id.*

65. Because Pirrone formally initiated the discussions that led to the modification actually adopted, Monarch might argue that it should not have the burden of persuasion. Further, Monarch might argue that Pirrone had waived its 1969 claim since Pirrone did not reassert it until the suit. On the facts as stated in the opinion, neither argument should prevail. Given the circumstances, Monarch's action motivated Pirrone to making the best out of a bad situation and an additional request for the 1969 performance would have been useless. See Hillman, *supra* note 23, at 865-66.

This Article's discussion of the Code argues that the current problem has been the refusal of courts to consider the extortion problem, not that the UCC solution is necessarily incorrect. Under the Code, the promisor could be allocated the burden of persuasion, meeting it by showing the absence of unforeseen circumstances. This solution raises a problem to the extent that showing the absence of unforeseen circumstances is more difficult than showing their presence, but it is preferable to the current performance of courts interpreting the Code.

66. Relevant evidence will include a promisor argument that some (per-

isor rejection of a lower-cost alternative indicates that the modification was not extorted. On the other hand, if the promisee met this burden by showing unanticipated circumstances, the modern common law would allow the promisor to rebut the resulting inference of mutual benefit from the modification.⁶⁷ For example, the promisor could attempt to show that the modification was accepted only when the promisee was able but unwilling to continue without it, thereby rebutting the "unanticipated circumstances" claim. Allowing promisor rebuttal is defensible, although it will increase litigation costs and may cause the case to be decided upon subjective evidence such as the jury's direct evaluation of whether the promisor benefited. Because the promisor could have benefited does not in itself mean that the modification was accepted for this reason. For example, in *Schwartzreich v. Bauman-Basch, Inc.*,⁶⁸ although the promisee-designer might have successfully argued both that the second job offer was unanticipated at the time of the original contract⁶⁹ and that the promisor benefited, for example by an enhanced reputation for fair dealing, the promisor still might have agreed only because the market and litigation alternatives were less preferable. Apparently because of this possibility, even if a jury finds that the promisee has met the burden regarding unanticipated circumstances, the effect of the common law position is to force the jury to decide whether the promisor's rebuttal evidence indicates extortion.⁷⁰

haps subjective) aspect of the promisee's performance made the promisee a lower-cost alternative than others even though another person in the promisor's position might have considered the promisee a higher-cost alternative.

67. See RESTATEMENT (SECOND) OF CONTRACTS § 89D, Comment b (Tent. Draft No. 1-7, 1973).

68. 231 N.Y. 196, 131 N.E. 887 (1921). See notes 31-35, 55-56 *supra* and accompanying text.

69. Depending upon the nature of the original contract and of the second offer, the promisor might successfully argue that the second offer was anticipated and the risk of such an offer was allocated to the promisee in the original contract. For a recent case illustrating how a contingency that increases the burdens of performing was anticipated, see *Mobile Turnkey Hous., Inc. v. Ceafco, Inc.*, 294 Ala. 707, 321 So.2d 186 (1975) (adverse subsoil conditions are not an unanticipated circumstance when a contract unambiguously provided for this contingency). For an earlier example, see *Hoskins v. Powder Land*, 90 Ore. 217, 176 P. 124 (1918) (promisee claimed that he was forced to haul earth farther than originally supposed but he had stipulated his personal knowledge of conditions on the work-site).

70. For an example of the promisor winning in such a case, see *Rexita Constr. Co. v. Midwest Mower Corp.*, 267 S.W.2d 327 (Mo. App. 1954) (Despite possible unforeseen circumstances, the promisor complied only after finding no other alternatives and stopped complying with the modification as soon as it found a substitute at a price less than the modification. The modification was

Because the factual circumstances will vary widely from case to case, only the most general guidance can be offered regarding the standards a jury should apply when the promisor attempts to rebut the inference of mutual benefit that is raised by the promisee's showing of unanticipated circumstances. Instructing the jury to focus on the promisor's motive is more a conclusion than a guide, given the difficulty of determining motivation directly. Some facts are, however, relevant to an indirect determination. For example, the promisor's response to the proposed modification can be important. A jury may view willing acquiescence to the modification as more damning than promisor protest, absent indications that protest would have been useless. Evidence of the promisee's ability to perform will also be relevant—a showing that the promisee was close to bankruptcy would be especially strong evidence in favor of the promisee. There occasionally may even be evidence, such as a "hot" document, revealing that the promisee was fully able and willing, if necessary, to perform.⁷¹ In evaluating the evidence, the jury can also examine the strength of the inference raised by the claim of unanticipated circumstances. The closer these circumstances come to excusing the duty of the promisee under the original promise, the stronger the inference of mutual benefit will appear, all else being equal.⁷² Due to the absence of judicial discussion of these issues in relevant cases, it is unclear exactly how a fact finder will use these facts in practice. Nevertheless, explicit attention to these issues should improve handling of them, given the judicial experience that will accrue over time. In any event, cases of genuine doubt, which undoubtedly will occur, will be resolved in favor of the prom-

not enforced, although the court's reasoning, but not result, was inconsistent with opportunism analysis.)

Of course, this is not to argue that the jury is limited to questions of extortion when determining the enforceability of a modification; for example, the statute of frauds or reasonable reliance may also be relevant.

71. Analytically, perhaps this point of promisee bluffing should be dealt with in terms of whether the circumstances were linked to the reason for not performing. See note 37 *supra*. Thus, even after the promisee presents evidence of unanticipated circumstances, rather than trying to rebut the inference these circumstances raise, the promisor may argue that the inference should not be raised in the first place.

72. This point follows because the closer the circumstances come to excusing the promisee's duty under the original contract, the harder it is for the promisee to perform, all else equal. The more difficult performance is for the promisee, the more likely is damage to the promisee-promisor relationship if the promisor does not agree to the modification. Thus, the closer the unanticipated circumstances are to excusing the original promise, the more the promisor has to gain from the modification.

isee, because the promisee's showing of unanticipated circumstances places the burden of persuasion on the promisor to present an adequate rebuttal.

The focus on unanticipated circumstances has at least one more important practical consequence. When such circumstances exist, the promisor has an added incentive to resist extortion because an unprotesting agreement to the modification may cause the jury to find for the promisee. Promoting such promisor resistance adds another cost to a rule that allows the promisor to rebut the inference of mutual benefit from unanticipated circumstances. Perhaps, however, this cost is justified because more effective protests would decrease the number of extorted modifications that courts ultimately enforce, and hence decrease the incentive to extort. Thus, benefits exist to offset the costs of promisor resistance, although again the relative magnitudes of the costs and benefits are uncertain.

The effect of the modern pre-existing duty rule reflects an approach to modifications that this Article has developed and analyzed. This approach varies from the law of duress, since absent new consideration, the common law appears to allocate the burden of persuasion to the party favoring the modification, the promisee, even if the increased cost to the promisor relative to the original contract is slight. Only gross disparities in the benefits exchanged raise an inference of possible duress.⁷³ Because of this feature of the law of duress, one commentator has recently suggested that the promisor must incur substantial extra costs from the modification before the promisee should have to show that the modification was not extorted.⁷⁴ Thus, the question arises whether the difference in approach between the law of modification and that of duress is justified, since both might be used against "extorted" modifications.

Implied in the principle that courts should not question the

73. See Hillman, *supra* note 23, at 880-88. "Unfair surprise" or "unconscionability" (as used in Epstein, *Unconscionability: A Critical Reappraisal*, 18 J. L. & ECON. 293, 301-05 (1975)) are alternative concepts for "duress" in this context.

Historically, duress was rarely used to void modifications, see Dalzell, *supra* note 21, at 255-76, and a modification obtained by a threat to breach a contract was not considered duress. See *id.*; RESTATEMENT OF CONTRACTS §§ 492-493 (1932). More recently, however, duress has been defined to include threats when no reasonable alternative exits. See RESTATEMENT (SECOND) OF CONTRACTS §§ 317-318 (Tent. Draft No. 12, 1977).

74. See Hillman, *supra* note 23, at 885-88. Hillman would determine whether the deviation was substantial by looking to the criteria that courts use to distinguish material from immaterial breaches. *Id.* at 887-88.

adequacy of consideration⁷⁵ is the concept that value is subjective. Only the parties to an agreement can know for certain the precise values that they place on the promises exchanged. Thus, if the law of duress is to respect this subjectivity, it must insist upon "gross" disparities of exchanged values. With a modification, however, the parties have already revealed important information about their subjective valuations through the terms of the first contract. Given this knowledge, any deviation that seems to benefit only one party, such as occurs in a modification without consideration, raises an inference of possible extortion.

This distinction does not preclude justification of the deviation from the original terms, such as by showing unanticipated circumstances, nor does it prevent the normal duress rule from applying when the modification has new consideration. Moreover, the difference between duress and modification law does not mean that shifting the burden of persuasion, even following modifications that vary slightly from the original terms, will cause promisors to pursue worthless claims. If the minor variation causes no harm to the promisor—for example, the buyer agrees that the seller can deliver one week late when the delay will not harm the buyer—the promisor-buyer has no incentive to challenge the modification because a court would not award damages.⁷⁶

To summarize, the possibility of opportunistic behavior has been shown to justify some restriction on contractual freedom. Not all modifications should be enforced, with the reason for modification determining enforceability. Because some reasons are difficult to determine, rules should be developed to facilitate distinguishing extortive from mutually beneficial reasons. The modern common law appears to reduce transaction costs by allowing at least some contracting parties to rely upon an implicit legal term against extorted modifications without resorting to more costly methods of protection. The common law's focus on new consideration⁷⁷ and unanticipated circum-

75. See, e.g., 1 A. CORBIN, *supra* note 1, § 127.

76. The lesser the deviation, the lesser are the promisor's damages and the less likely the promisor will be to litigate.

77. Because parties receive new benefits in a modification with new consideration, courts can safely assume, with the assumption being rebuttable, that the exchange is not extorted. There must be more than a pretense of consideration, however, and hence promisees cannot use sham transactions to avoid the burden of persuasion. See RESTATEMENT (SECOND) OF CONTRACTS § 76A, Comment c (Tent. Draft No. 1-7, 1973).

It has also been frequently suggested that a modification should be pre-

stances has a beneficial effect in allocating the burden of persuasion. Indeed, the modern common law position as interpreted here performs well in deterring opportunism.⁷⁸

B. GOOD FAITH IN PERFORMANCE

The Uniform Commercial Code provides that "[e]very contract or duty within this Act imposes an obligation of good faith in its performance or enforcement."⁷⁹ Although the Code offers no better definition of good faith than "honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade,"⁸⁰ the term pervades the Code's law of sales: thirteen provisions in Article 2 explicitly use "good faith," while twenty others have comments containing the term.⁸¹ Moreover, although the decisions vary from one jurisdiction to another, common law courts have deemed good faith relevant at every

sumed valid in cases in which a third party, *C*, promises to pay *A* if *A* will perform his or her contract with *B*. See, e.g., 1 A. CORBIN, *supra* note 1, § 176; S. WILLISTON, *supra* note 32, §§ 131, 131A; RESTATEMENT OF CONTRACTS § 84(d) (1932); RESTATEMENT (SECOND) OF CONTRACTS § 76A, Comment d (Tent. Draft No. 1-7, 1973). The primary argument for this position appears to be that there is no harm in these promises since third parties cannot be extorted. See, e.g., 1 A. CORBIN, *supra* note 1, at 125. This argument, however, ignores that there may well be external benefits to *C* from the *A-B* contract and that *C* may be willing to pay to receive those benefits. With such benefits, the incentive for opportunistic behavior exists. A particularly graphic example involves a third party who promises to obtain benefits as a family member. See, e.g., *Hale v. Brewster*, 81 N.M. 342, 467 P.2d 8 (1970) (relative of indigent client promised lawyer money to prosecute appeal on behalf of client who lawyer represented at trial); *De Cicco v. Schweizer*, 221 N.Y. 431, 117 N.E. 807 (1917) (father promised benefits to prospective son-in-law contingent upon marriage).

Thus, if the validity of third party promises can be presumed, new consideration would appear to furnish a basis. If *A* breaches, *A* would be liable in damages to both *B* and *C*, with this increased liability representing the promisee's consideration for the promise. (Of course, a separate problem concerns whether *C* can prove damages, a problem that *C* can alleviate with a stipulated damage clause.) Enforcing the third party contract has the added benefit of making *A* face the true costs that a breach would cause. Again, extortion can be shown to rebut the inference of validity.

78. The common law position deters opportunism unless, of course, one can assume that most litigated modifications are valid or that the costs of the promisor's rebuttal of the inference of benefit drawn from unanticipated circumstances exceed the benefits of such rebuttal.

79. U.C.C. § 1-203. See RESTATEMENT (SECOND) OF CONTRACTS § 231 (Tent. Draft No. 1-7 1973). This section discusses the general concept of good faith in performance of the contract, suggesting some parameters to this vaguely defined concept. Except for stipulated damages, the other examples discussed in this part are sometimes said to involve the concept of good faith. See notes 93-137 *infra* and accompanying text.

80. U.C.C. § 2-103(1)(b).

81. See Summers, *Good Faith in General Contract Law and the Sales Provisions of the Uniform Commercial Code*, 54 VA. L. REV. 195, 212, 219 n.91 (1968).

stage of the contracting process, from negotiation through remedy. This Article will not survey the broad field of good faith, but instead will analyze several recurring issues of good faith in the performance of contracts: prevention of performance, quantity variations in requirements and output contracts, percentage leases, bad faith interpretation, and "willful" substantial performance. These issues are not discussed in all of their detail, but they are considered in sufficient depth to demonstrate that reliance on good faith is a common response to opportunistic behavior, thus infusing the good faith concept with more unity than has commonly been acknowledged.⁸² Finally, the deterrence of opportunistic behavior will be shown to provide a firmer, more rigorous basis for condemning bad faith than other approaches.

1. *Prevention of Performance*

It has long been settled that when one party prevents or hinders the performance of another, the nonhindering party's duty to perform is excused: such conduct can even constitute a breach of contract.⁸³ How to determine whether one party's "hindering" act is sufficient to invoke the doctrine, however, remains unsettled. Words such as fairness, justice, and good faith provide at best only tenuous guides. Moreover, if the prevention doctrine is of uncertain usefulness, parties may rely on other devices to protect themselves, such as adding clauses to the contract detailing permissible and impermissible behavior.

The principles underlying the condemnation of opportunistic behavior provide a surer guide. Consider the well-known cases of *Patterson v. Meyerhofer*⁸⁴ and *Iron Trade Products Co. v. Wilkoff Co.*⁸⁵ In *Patterson*, the plaintiff had agreed to sell four specifically identified houses to Meyerhofer for \$23,000. Although Patterson did not own the houses at the time of the

82. See, e.g., Summers, *supra* note 81, at 199-207. This Article does not claim to explain completely all individual uses of "good faith," or even to explain all uses of good faith with a foundation in costs or other economic considerations. For example, the doctrine of mitigation of damages is often seen as one of good faith, see, e.g., F. KESSLER & G. GILMORE, *CONTRACTS* 976-90 (1970), and can perhaps be explained as encouraging the shift of resources to their highest valued uses.

83. See 3A A. CORBIN, *supra* note 1, §§ 767-771; 6 A. CORBIN, *supra* note 1, §§ 1264, 1323; RESTATEMENT OF CONTRACTS §§ 295, 315 (1932); RESTATEMENT (SECOND) OF CONTRACTS §§ 231, 269 (Tent. Draft No. 1-7 1973).

84. 204 N.Y. 96, 97 N.E. 472 (1912). The facts of *Patterson* are taken from the majority opinion. A three-judge dissent viewed the facts differently than did the four-judge majority. See 204 N.Y. at 102-07, 97 N.E. at 473-75.

85. 272 Pa. 172, 116 A. 150 (1922).

contract, both parties understood that he planned to purchase them at a foreclosure sale and that he hoped to make a profit by paying less than \$23,000. Meyerhofer appeared at the foreclosure sale and bid against Patterson. In every instance of a Patterson bid, Meyerhofer bid higher, with Meyerhofer's successful bid totaling \$22,350. In *Iron Trade* the parties had agreed to the sale and purchase of 2,600 tons of rails. Circumstances indicated that the buyer desired to buy as many rails as possible and that the 2,600 tons represented only part of its planned purchases. Apparently, rails were available in quantities large enough to fill the contract in only two locations—one in Georgia and another in West Virginia. When the seller under the contract was negotiating to purchase rails to fulfill the contract, the buyer announced its urgent desire to purchase rails, then bought 887 tons and agreed to purchase a much larger quantity from the suppliers with whom the seller had been negotiating, thus reducing the available supply of rails and raising their price. The seller did not deliver any of the 2,600 tons of rails.

In both cases the seller under the contract was forced to compete with its own buyer in purchasing the commodity that was the subject of their bargain, and in both the seller chose not to match the buyer's competition. Nevertheless, in *Patterson*, the buyer's conduct was held to be impermissible,⁸⁶ while in *Iron Trade*, the court found the conduct permissible.⁸⁷ How can these cases be reconciled? They cannot be distinguished on the basis that there was prevention in *Patterson* and only hindrance in *Iron Trade*. In both cases, the seller could have outbid the buyer. Nor did explicit wording in the *Iron Trade* contract permit the buyer's behavior and thus distinguish the cases.⁸⁸ The distinction suggested in the *Second Restatement*—

86. 204 N.Y. at 101, 97 N.E. at 473.

87. 272 Pa. at 176-77, 116 A. at 151.

88. Although some commentators imply that the cases are indistinguishable, others argue that the cases can be distinguished on the basis that in *Iron Trade* the seller assumed the risk of competition from the buyer. See, e.g., RESTATEMENT OF CONTRACTS §§ 295, 315 (1932); Patterson, *Constructive Conditions in Contracts*, 42 COLUM. L. REV. 903, 937 (1942). This argument, however, does not explain how an assumption of risk can be found in some cases when the contract is silent on the issue, but not in others. This problem is made more acute because those who argue for the risk distinction also argue that individuals do not assume the risk that their performance will be prevented. See, e.g., Patterson, *supra*, at 935. This is not to say that the parties cannot allocate the risk on custom or on an explicit term if they so choose. See text accompanying note 92 *infra*.

that the buyer in *Iron Trade* was not malicious⁸⁹—does not seem useful either. This test requires knowledge of the buyer's subjective intentions. Further, a buyer who had originally intended to buy elsewhere would know, or should know, that such a practice would make the seller's performance more difficult. There is no reason to condemn the buyer for this alone, yet determining what additional facts constitute "maliciousness" would be extremely difficult in practice.

The analysis of opportunism presented in this Article, however, offers a principled distinction. In *Patterson*, given the contract, the buyer had already made provision for the purchase of the four houses.⁹⁰ Thus, the buyer's behavior appeared to have the sole function of transferring wealth from the seller (who lost his expectation) to the buyer.⁹¹ On the other hand, in *Iron Trade*, it appeared that the buyer desired the 2,600 rails specified in the contract in addition to those that it purchased in competition with its contracting party. Thus, the competition in *Iron Trade* was not merely to avoid paying the contract price. In *Patterson*, once the original contract existed, the buyer's conduct not only wasted the resources spent on the conduct, but, if permitted, would also have wasted resources

89. See RESTATEMENT (SECOND) OF CONTRACTS § 262, Illustrations 6 & 7 (Tent. Draft No. 8, 1973). For a similar approach to the prevention problem applied in a much different context, see McDermott, *Defining Manipulation in Commodity Futures Trading: The Futures "Squeeze,"* 74 NW. U.L. REV. 202, 215-19 (1979).

90. There is nothing in the *Patterson* facts indicating that, absent Meyerhofer's acts, Patterson would have failed to purchase the houses at the auction. If Patterson would have failed to do so, however, Meyerhofer's actions would have been justified. See RESTATEMENT (SECOND) OF CONTRACTS § 295 (Tent. Draft No. 10, 1975); *id.* § 315 (Tent. Draft No. 12, 1977).

In *Iron Trade* the court specifically noted that the seller did not allege that the supply of rails was "limited." 272 Pa. at 174-75, 116 A. at 150. Although supplies of all items are in some sense limited, the court's statement appears to refer to the absence of a claim that the available supply of rails was only enough to fill the first contract or that the buyer's additional purchases reduced the remaining supply below 2,600 tons.

91. Throughout this discussion of good faith in performance, opportunistic conduct is defined as conduct whose sole effect is to transfer wealth. The problem with the wealth transfer is not that the party losing wealth (the seller in *Patterson*) has an initial right to the wealth. See text accompanying note 11 *supra*. Instead, the problem is that the difference between a rule permitting the opportunistic act and one prohibiting it is one of the parties' wealth, not one of whether the buyer ends up with the houses. Because the buyer ends up with the houses in either case, the rule that lowers the cost of exchange is preferable. Prohibiting the buyer's behavior when its only result is to transfer wealth discourages such behavior and accordingly reduces the amount of resources spent on it and protecting against it. See generally notes 5-21 *supra* and accompanying text.

that future sellers could have spent to avoid such conduct, for example, by negotiating contractual clauses to prevent it.

Of course, parties in a *Patterson* situation should be allowed to agree that the buyer could bid against the seller. Although such agreement seems unlikely, one can envision contracts permitting such competition. For example, owners of a house who desire to sell may hire a broker while retaining the privilege of selling on their own.⁹² But, if the parties do not want to bargain for such a privilege, using opportunism to guide application of an implicit prevention term facilitates use of simple contract terms.

2. *Quantity Variations in Requirements and Output Contracts*

Requirements contracts, by which buyers agree to buy all they need from one source, and output contracts, by which sellers agree to sell all they produce to one source, do not specify the precise quantity to be transferred. Such contracts provide obvious mutual benefits, including the flexibility of not specifying quantity until information unavailable at the time the contract is formed comes into existence. The question of breach often arises when a quantity tendered or ordered varies significantly from past quantities, or when performance has recently begun and the tender or order varies from the pre-contract requirement or output. Both the common law and the U.C.C. attempt to control variations by permitting only those made in good faith.⁹³ This analysis focuses on variations in requirements, by far the most common issue in the litigated cases, and demonstrates that despite the complexity of the issues underlying a good faith/bad faith distinction, sensitivity to opportunism provides a principled basis for distinguishing good from bad faith.⁹⁴

92. See, e.g., 3A A. CORBIN, *supra* note 1, § 768.

93. See Weistart, *Requirements and Output Contracts: Quantity Variations Under the UCC*, 1973 DUKE L. REV. 599, 600. See also J. WHITE & R. SUMMERS, *supra* note 23, at 121-27.

Williamson argues that quantity variations in contracts with idiosyncratic aspects are unlikely to be opportunistic because those aspects imply significant costs to the opportunists from switching. See Williamson, *Transaction Cost Economics: The Governance of Contractual Relations*, 22 J.L. & ECON. 233, 251 (1979). This Article contends that opportunism is still possible even with relatively low costs of switching. Moreover, it also suggests that opportunism can occur with products much less specialized than those that Williamson analyzes.

94. Output contracts involve similar issues. For a brief discussion of some of the differences between output and requirements contracts, see note 114 *infra*.

The case of a requirements buyer reducing purchases provides an initial illustration of the potential for opportunistic behavior. Opportunism can occur when the requirements contract price exceeds the market price, giving the buyer the incentive to avoid the contract when the costs of avoidance are less than the gain from paying a lower price. The contract-market price difference determines the amount that the buyer can profitably spend to avoid purchasing the requirements under the contract. In addition to these costs, the buyer's action may cause the seller to incur costs in selling elsewhere that the seller otherwise would not have incurred. Moreover, the seller may take steps to avoid similar action by buyers in the future, such as by adding additional contractual detail. Unless either the contract explicitly permits the buyer's conduct or such permission is implied in the agreement by custom or by some other standard process of implication,⁹⁵ the buyer should be prohibited from diverting his or her purchases, thereby eliminating the costs that such diversion causes.

A relatively easy case involves buyers who, in an attempt to satisfy their needs elsewhere, deny that they have requirements. In *Western Oil & Fuel Co. v. Kemp*,⁹⁶ for example, the buyer agreed to purchase its needs of certain oil products for two years. Before the contract expired, the buyer formed a new corporation with one of the seller's competitors. The buyer was the corporation's manager and the competitor was the supplier of oil products to the new corporation. The court rejected the buyer's argument that the change in corporate form left it with no requirements and instead found the buyer to have acted in bad faith.⁹⁷ Forming the new corporation was costly. If its formation benefited the buyer only by lowering the price of the oil products, the diversion merely shifted wealth

95. The explicit terms can distinguish opportunism from a losing contract. For example, when the buyer sells too cheaply, the contract explicitly sanctions the seller's request for delivery and thus opportunism is not present. For a case approving an increase in requirements partly on the ground of custom, see *Eastern Air Lines, Inc. v. Gulf Oil Corp.*, 415 F. Supp. 429, 431-37 (S.D. Fla. 1975) (Although the buyer purchased in excess of his needs, seller knew of the practice and never complained until the market price rose sharply. The opinion gave no indication that buyer manipulation had increased with the price rise.)

96. 245 F.2d 633 (8th Cir. 1957).

97. *Id.* at 637. For a case similar in facts and result to *Western Oil*, see *Humble Oil & Ref. Co. v. Cox*, 207 Va. 197, 203-06, 148 S.E.2d 756, 761-63 (1966) (buyer still in fact had requirements, although court argued buyer liable because of an implied promise to have requirements). See also *Texas Indus., Inc. v. Brown*, 218 F.2d 510, 512-13 (5th Cir. 1955) (decrease not sanctioned when requirements buyer of an input for manufacturing plants leased plants to others, claiming that lease ended duty to buy).

from the original seller at the expense of the costs that both parties incurred.

Another example of possible opportunism involves the owner of several plants who agrees to buy all inputs for a particular plant from one seller but, part way through the contract, closes or significantly curtails this plant and fills the orders that the seller under contract would have supplied from a more distant seller. If the plant curtailment and subsequent reduced requirements were prompted by input prices for the other seller falling below the contract price, then the reduction is opportunistic. If the same inputs are used in both plants at no difference in the cost of the resources used to produce them, then the owner's gain transfers wealth from the seller at the expense of at least the increased transportation costs. Of course, other factors could motivate the reduction. For example, the other plant might have lower costs or the owner might want to take advantage of volume-based cost reductions by consolidating product runs into one plant. Independent of opportunism, these motives could explain the reduction even when input prices had dropped.⁹⁸

Reduction in requirements also occurs when the buyer purchases a substitute product that can be put to the same use as the contract good. One form of opportunism involves a buyer who purchases a substitute that was available but was relatively unattractive in price at the time the requirements contract was formed, but that is now cheaper than the contract price.⁹⁹ *Loudenback Fertilizer Co. v. Tennessee Phosphate*

98. For decisions sanctioning a large decrease, see, e.g., *R.A. Weaver & Assoc., Inc. v. Asphalt Constr., Inc.*, 587 F.2d 1315, 1319-21 (D.C. Cir. 1978) (contractor of a government construction project had no requirements when government legally changed contract specifications); *Fort Wayne Corrugated Paper Co. v. Anchor Hocking Glass Corp.*, 130 F.2d 471, 473-74 (3d Cir. 1942) (court explicitly found that plant closing was not to avoid contract nor to divert business to other of buyer's plants); *Romine, Inc. v. Savannah Steel Co.*, 117 Ga. App. 353, 355, 160 S.E.2d 659, 661 (1968) (reduction of estimated requirements resulted from mistake in specifications without fault of either party); *Western Sign, Inc. v. Montana*, 590 P.2d 141, 144 (Mont. 1979) (court implies that seller unreasonable in belief that buyer's requirements would be in excess of quantity actually ordered); *Wilsonville Concrete Prod. v. Todd Bldg. Co.*, 281 Or. 345, 352, 574 P.2d 1112, 1115 (1978) (government contractor not required to continue purchases under requirements contract when state terminated contract); *Berkeley City Pub. Serv. Dist. v. Vitro Corp. of America*, 152 W. Va. 252, 262-72, 162 S.E.2d 189, 200-02 (1968) (the buyer of water requirements for 40 years closed an aircraft plant, built at a cost of \$800,000 and planned for 700 employees. Small sums were involved—properly at issue was only the seller's claim for \$275 per month—relative to the magnitude of the cost of not using the plant and evidence of good faith reasons for closing existed).

99. A more complicated problem involves a substitute either created after

*Co.*¹⁰⁰ provides an illustration of an opportunistic substitution. In *Loudenback*, a requirements buyer of phosphate rock used the rock as a base for making "complete" fertilizer or treated it with sulphuric acid to sell as "incomplete" fertilizer. For two years, the buyer placed no orders, instead ordering "incomplete" fertilizer elsewhere. When the market price of the rock rose, making the requirements contract more attractive than purchases of the incomplete fertilizer, the buyer ordered the maximum allowed under the contract. The buyer sued when the seller refused to deliver, but the court sustained the seller's demurrer, reasoning that the buyer's initial substitution of incomplete fertilizer for the phosphate rock breached the contract.¹⁰¹ This decision correctly deters opportunism—the buyer's purchase of the incomplete fertilizer simply transferred wealth from the seller to the buyer at the expense of the costs incurred to arrange the purchase and any expenses the seller incurred to sell elsewhere that would not have been incurred without the breach.¹⁰²

In contrast, *Southwest Natural Gas Co. v. Oklahoma Portland Cement Co.*¹⁰³ presents a non-opportunistic substitution situation. Portland Cement was a requirements buyer of gas for fuel, heating, and other purposes in running its plant. At the time the requirements contract with Southwest was formed, Portland used boilers that produced waste heat that escaped into the air. When its boilers became unsafe, the company installed a new system with boilers closer to the plant that used the waste heat, resulting in a large reduction in purchases from Southwest. The court found the substitution to be in good faith. Because Portland Cement apparently incurred only costs it would have borne without the requirements contract,¹⁰⁴ this result is consistent with deterring opportunism.

Thus, requirements contracts present a recurring pattern. Parties prefer simple contract language, in this case clauses that do not precisely specify quantity. Yet, to avoid becoming victims of opportunism, they incur costs that can offset the ad-

the contract began or developed through new technology that did not exist at the time of the contract. See text accompanying notes 105-14 *infra*.

100. 121 F. 298 (6th Cir. 1903).

101. *Id.* at 304-05.

102. The buyer did avoid the cost of treatment, but this is strictly a private saving since the "incomplete fertilizer" that he purchased was itself treated. *Id.* at 299.

103. 102 F.2d 630 (10th Cir. 1939) (approved in U.C.C. § 2-306, comment 2).

104. *Id.* at 633.

vantages of this simplicity. Because only some decreases are opportunistic, a problem of subtlety exists, and the issue becomes how to distinguish opportunistic from nonopportunistic behavior.

One approach treats the contract as if the buyer agreed to refrain from any reductions so long as it remains in the business for which it entered the contract.¹⁰⁵ Under this approach, reductions in requirements compel the buyer to pay the seller the difference between the market price and the contract price as well as the seller's additional costs of finding a substitute buyer. Because there would also be costs of buying elsewhere, the buyer reduces purchases only if the gains (for example, purchasing a substitute whose price was below the market price of the contract good) exceeded both the buyer and seller's costs resulting from the buyer going elsewhere. Thus, the buyer cannot gain at the seller's expense.

Such a rule of automatic buyer liability is not without problems, however, the most obvious of which arise with the development of new technology. Consider, for example, a late nineteenth-century delivery firm, *B*, with a contract to buy its horse-drawn cart requirements from *S* for \$500 per cart (which represents the cost of the resources used in production). Assume further that trucks are invented after the contract is signed and sell for \$500 each, that *B* wishes to purchase ten trucks in the period remaining under the requirements contract, and that, after the invention of trucks, carts fall to a price of \$250 (representing the new market as well as *B*'s value for

105. For a decision reaching such a conclusion, see *Chalmers & Williams v. W. Bledsoe & Co.*, 218 Ill. App. 363 (1920). The *Chalmers* court disapproved of the use of new technology, but the analysis gave little attention to the circumstances of the transaction and was therefore less convincing than if it had shown actions of the parties supporting its result. For example, in some cases the seller has relied, with the buyer's knowledge and consent, on the expected sales under the contract by making expenditures not otherwise justified. See, e.g., *Diamond Alkali Co. v. P.C. Tomson & Co.*, 35 F.2d 117, 118 (3d Cir. 1929) (seller expanded his capacity to furnish buyer's requirements); *Paramount Lithographic Plate Serv., Inc. v. Hughes Printing Co.*, 2 Pa. D. & C. 3d 677, 679 (1977) (supplier of requirements of lithographic plates sunk costs on facilities at a specific location in anticipation of buyer's printing press being ready and when buyer moved press elsewhere, resulting in lack of requirements, court found buyer in breach). For disapproval of an increase in requirements based in part on similar buyer reliance, see *Utah Int'l, Inc. v. Colorado-Ute Elec. Assoc., Inc.*, 425 F. Supp. 1093, 1100 (D. Colo. 1976) (when seller reasonably planned for buyer's requirements based on buyer's plant capacity being 350,000 kilowatts, and buyer built for 410,000, court held seller liable only for requirements of the smaller size).

carts used in *B*'s business).¹⁰⁶ Finally, assume that *B*'s cost of making a truck contract is \$100 and that *S*'s additional cost of selling the carts to someone else is \$100.

Assuming for the moment that *S* has enough carts in stock to satisfy *B*'s needs, under the rule of automatic buyer liability, *B* could breach only if it compensated *S*. To purchase the equivalent of 10 trucks, the buyer would need to purchase 20 carts,¹⁰⁷ which means the buyer-liability rule would require *B* to compensate *S* for its contract-market loss on 20 carts.¹⁰⁸ Given that *B* would also incur \$200 from the cost of the truck purchase and *S*'s cost of resale, *B* will not breach. This result can be justified on cost-minimizing grounds because it saves the \$200 from being spent.¹⁰⁹

Notice, however, that compared to a competitor who did not buy carts at \$500, *B* is at a disadvantage. Depending upon the length of the contract and the importance of the new product to *B*, compliance with the terms of the contract could force *B* out of business. Although it is widely understood that a requirements buyer bears the risk of other sellers more cheaply providing the contract good, it does not follow that the buyer also bears the risk of new technology producing a superior substitute for the contract good. Thus, in addition to opportunism, courts must at least implicitly consider risk allocation in determining whether to establish a rule of buyer liability.¹¹⁰

106. A substitute good priced below the market price of the contract good exerts downward pressure on the market price of the latter good. Whether the prices become equal depends upon whether the substitute can be used for all uses of the contract good. In any event, if the contract good was selling at marginal cost before the price of the substitute dropped, the contract good will no longer be profitable to produce, assuming there are no other changes in the demand and cost for the contract good.

107. As represented in their respective prices, *B* values trucks at twice the value of carts.

108. In other words, *B* faces an equal-cost choice considering just these elements of the liability rule: \$10,000 under the contract for 20 carts at \$500 each, or \$10,000 for the trucks plus damages (10 trucks at \$500 each, plus contract-market losses of \$250 for each of the 20 carts).

109. If *B* is not liable to *S*, *B* will still prefer to buy carts at \$250 if the costs of their agreeing on the lower price are less than \$100. This is simply an application of the well-known Coase Theorem. See Coase, *The Problem of Social Cost*, 3 J. L. & ECON. 1, 6-44 (1960).

110. To a significant extent, the question of risk allocation is one of contract interpretation. See note 95 *supra* and accompanying text. For example, an explicit term of the contract or industry custom might allocate risk. Thus, the requirements buyer who purchases elsewhere when the market price drops is not in bad faith in the unlikely event that the contract allocated the risk of such a drop to the seller, thereby sanctioning the buyer's action. When the buyer has assumed the risk of the market price falling, however, decreases in the buyer's requirements should be policed via the opportunism standard. More-

Aside from risk allocation considerations, the new technology case raises other problems for a rule of automatic buyer liability. For one, if *B* approaches *S* for a renegotiation of the contract, the negotiation cost might exceed the costs of *S* selling and *B* buying elsewhere.¹¹¹ Moreover, if *S* does not have the old product on hand, holding *B* liable would definitely raise transaction costs. In our illustration, for example, because the market value of carts is below their production costs, it would not pay to make carts. *S*, however, could tell *B* that it will make carts to meet *B*'s needs unless *B* pays *S* not to produce. Depending upon the extent of any competitive disadvantage, *B* will make such a payment up to \$4900.¹¹² If *B* is not liable, *B* will still buy trucks, but without the negotiation between *B* and *S*, resources will be saved.

One can envision still other costs of the rule of buyer liability. Because *B* must pay *S* even when the result is not opportunistic, settlements and trials will occur that could be avoided with a rule that could better discriminate between good and bad faith. Further, resolving issues such as what *B*'s requirements would have been given *B*'s purchase of a different product, and whether *S* has spent the proper amount covering, can be quite costly.

A more direct, case-by-case determination of opportunism thus has advantages over the rule of automatic buyer liability. The more direct approach also has disadvantages, particularly in increased litigation and in other costs that result from uncertainty. These disadvantages can be partly reduced by focusing on objectively verifiable facts such as whether the market price has dropped below the contract price and whether, if a substi-

over, the seller ordinarily assumes the risk of the contract price forcing the buyer to charge a higher price than his competitors, thereby decreasing requirements. See Weistart, *supra* note 93, at 610. To the extent risk allocation is a question of interpretation, the issue is analytically prior to that of opportunism. Risk allocation can also be discussed in another sense, namely which party is able to bear the risk at lower cost. See generally Posner & Rosenfeld, *Impossibility in Related Doctrines in Contract Law: An Economic Analysis*, 6 J. LEGAL STUD. 83 (1977). Although discussion of this issue is largely beyond the scope of this Article, in allocating risk of a new technology, it would also be appropriate to consider the cost factors that the opportunism analysis reveals.

111. Although one could easily imagine that one transaction between *S* and *B* would cost less than two transactions, *S* might doubt *B*'s claim about imminent bankruptcy because, for example, *S* may think that *B* has advantages over *B*'s competitors in other costs. Alleviating such suspicions would increase the cost of the *S-B* bargain. There may also be a well-defined market for carts and trucks, reducing the costs to *B* and *S* from *B*'s buying elsewhere.

112. The amount *B* saves by buying 10 trucks as opposed to 20 carts at \$500, less *B*'s \$100 cost of making the truck contract, equals \$4900.

tute is purchased, the substitute involves technology developed since the requirements contract was formed. If the market price has not dropped, opportunism did not motivate the decrease,¹¹³ if a new technology is involved, it is more likely that the seller bears this risk. In fact, courts have adopted the more direct approach, resulting in numerous decisions consistent with this opportunism rationale.¹¹⁴

Problems created by a large increase in requirements are in many ways similar to those of a large reduction. In general, opportunism involves a buyer who, finding the contract price is below the market price, incurs costs that other buyers without the price advantage will not incur. For example, consider a buyer who is a retailer. With a purchasing advantage, the retailer could increase "requirements" to ship goods into markets where it previously had not sold, but can now profitably sell even with the increased transport cost. Despite the increased transport cost, the buyer benefits at the seller's expense.¹¹⁵

113. This analysis assumes that no problems of the so-called "lost volume" sale exist. A recent article argues that this problem is less frequent than many commentators and judges believe. See Goetz & Scott, *Measuring Sellers' Damages: The Lost-Profits Puzzle*, 31 STAN. L. REV. 323 (1979).

114. A few caveats are in order. First, the substantial support in the decisions for the opportunism theory comes from the results of the cases, not from the judicial language describing the criteria supposedly applied. Because the opportunism theory (and even on occasion good faith) is not explicit, some cases present insufficient facts from which to determine whether they are consistent with preventing opportunism. See, e.g., *Cannonsburg Iron, Ltd. v. McKeever*, 138 Pa. 184, 16 A. 97 (1888) (decrease in coal requirements approved when buyer substituted natural gas). In other cases, the circumstantial evidence of opportunism is strong and the court will stop its analysis there. See, e.g., *Smith v. Donk Bros. Coal & Coke Co.*, 260 S.W. 545, 546 (Mo. Ct. App. 1924) (buyer's requirements increased about three-fold when market price increased, and decreased to previous level when market price went back down). In still other cases, the court analyzes the problem as one of mutuality (i.e. consideration), when opportunism may have been relevant. See, e.g., *Intermountain Rural Elec. Assoc. v. Colorado Cent. Power Co.*, 322 F.2d 516, 518 (10th Cir. 1963) (buyer purchased elsewhere, but court did not discuss possible reasons for this on-its-face act of opportunism); *Crane v. C. Crane & Co.*, 105 F. 869, 871-72 (7th Cir. 1901) (contract to provide lumber void for lack of mutuality). An additional caveat is that good faith is not the only relevant issue in determining the legality of a variation. See, e.g., notes 105, 110 *supra* and accompanying text (reliance and allocation of risk). Finally, large increases in requirements produce the most controversy over the appropriate standards. See note 120 *infra*.

An analysis of output decreases is similar to that of requirements. Rather than a drop in the market price, however, a rise in the market price creates an incentive to reduce sales under the contract. In addition, the output is occasionally a by-product of some main product with changes in conditions of the main product affecting the quantity of the by-product produced.

115. Whether any price reduction that consumers receive should count as a benefit depends, in theory, upon the relationship of the buyer's price to the marginal cost of production for the good. If the buyer can price below marginal

The buyer might also engage in wholesale level competition with its seller, adding an extra transaction cost in the sale to the ultimate customers. Further, the buyer could spend more in stockpiling and encourage its customers to do the same. A final example of opportunism concerns a buyer who uses the contract good as an input in its production process. Because of a cost advantage from the contract, the buyer may seek to increase output and in so doing may run its plant faster, thereby increasing costs.¹¹⁶

*Oscar Schlegel Mfg. Co. v. Peter Cooper's Glue Factory*¹¹⁷ appears to involve an opportunistic increase in requirements. When the price of glue rose from the contract price of 9¢ to 24¢ a pound, the buyer increased its orders from 43,700 pounds for the first nine months of 1916 to 126,000 pounds for the last three months. The buyer apparently increased costs, in part by stockpiling supplies and urging its customers to do the same. The court found that the seller could lawfully refuse to fill the orders.¹¹⁸

Buyers, however, can have increases in requirements for nonopportunistic reasons. If a buyer has a purchasing advan-

cost, the gain to consumers would be viewed, under conventional economic theory, as a social loss. (The seller under the contract will sell below cost if it has other profitable sales or expects future sales to bring costs and revenues into balance.) If the buyer sold at above cost because competition was imperfect in the buyer's or seller's industry, the reduction is a social gain. Because most industries are at least workably competitive and because a contracts case is an improper device—given the small stakes usually involved—to decide difficult issues of the state of competition in an industry, the analysis in the text ignores any possible benefit from a lower price to consumers.

116. See Alchian, *Costs and Outputs*, in READINGS IN MICROECONOMICS 159 (2d ed. W. Breit & H. Hochman eds. 1971).

117. 231 N.Y. 459, 132 N.E. 148 (1921).

118. Some of the facts regarding opportunism can be found only in the dissent to the lower court opinion. See *Oscar Schlegel Mfg. Co. v. Peter Cooper's Glue Factory*, 189 A.D. 843, 845, 855-57, 179 N.Y.S. 271, 272, 279-80 (1919) *rev'd*, 231 N.Y. 459, 132 N.E. 148 (1921). The court of appeals reached the same result as the dissent, but relied on lack of consideration rather than on good faith.

For examples of opportunistic increases found to be in violation of the contract, see *City of Lakeland v. Union Oil Co. of Calif.*, 352 F. Supp. 758 (M.D. Fla. 1973) (buyer of oil used in generating electricity entered into new sales of electricity to another electric company upon price rise); *Dowd v. Hercules Powder Co.*, 66 Colo. 302, 181 P. 767 (1919) (evidence that buyer, a user of product, stockpiled and sold to other users); *Orange and Rockland Util., Inc. v. Amerada Hess Corp.*, 59 A.D.2d 110, 397 N.Y.S.2d 814 (1977) (very similar to *City of Lakeland*); *Asahel Wheeler Co. v. Mendleson*, 180 A.D. 9, 167 N.Y.S. 435 (1917) (in face of large price increase and stated requirements, buyer did not meet its burden of showing absence of speculation in increasing requirements); *Moore v. American Molasses Co. of New York*, 106 Misc. 262, 174 N.Y.S. 440 (1919) (court refused to enforce part of increase that represented sales to "non-regular" customers, including competitors of buyer).

tage over its competitors, the buyer might engage in extra purchasing for its existing stores without necessarily causing any more resource expenditures than would occur without the advantage; such purchasing would not be opportunistic, or in bad faith. Moreover, increased demand from the industry in which the buyer competes might cause a large increase in requirements for nonopportunistic reasons.¹¹⁹ Because allocation of the risk of such increases is relevant, issues similar to those concerning a new technology in the requirements cases are raised.¹²⁰

119. For examples of judges sanctioning nonopportunistic increases, see, e.g., *Marx v. American Malting Co.*, 169 F. 582 (6th Cir. 1909) (increase attributable to a new plant expanding the buyer's capacity—seller knew of plant, and construction apparently began before price rose); *Johnston Pie Co. v. Acme Egg & Poultry Co.*, 74 Cal. App. 2d 376, 168 P.2d 762 (1946) (buyer in fact had the requirements he claimed, although seller did not adequately discuss, nor did court consider, possibility that earlier behavior of buyer was a breach); *Ehrenworth v. George F. Stuhmer & Co.*, 229 N.Y. 210, 128 N.E. 108 (1920) (both parties desired sales of seller's pumpernickel bread to increase and over eight years buyer's orders increased from 50-60 loaves to 3000-4000 loaves per week); *N.S. Sherman Machine & Iron Works v. Carey, Lombard, Young & Co.*, 100 Okla. 29, 227 P. 110 (1924) (requirements of cement for use in construction of a water-works were in fact above estimate). Other cases have allowed the increase in the absence of proof of buyer bad faith. See, e.g., *New York Central Ironworks Co. v. United States Radiator Co.*, 174 N.Y. 331, 66 N.E. 967 (1903).

120. Although the issues raised are similar, their resolution need not be. For example, courts may find that sellers assume the risk of increases in demand more (or less) often than they assume the risk of new technology.

U.C.C. § 2-306(1) clearly adds a standard in addition to good faith for governing quantity variations:

A term which measures the quantity by the output of the seller or the requirements of the buyer means such actual output or requirements as may occur in good faith, *except that no quantity unreasonably disproportionate to any stated estimate or in the absence of a stated estimate to any normal or otherwise comparable prior output or requirements may be tendered or demanded.*

(emphasis added).

The "except that" proviso is largely irrelevant if opportunism is useful in understanding the good-faith limitation, as it appears to be. Nevertheless, three points about the proviso are relevant here. First, the meaning of the proviso is unclear. Comments 2 and 3 to § 2-306 only add to the confusion. Comment 2 approves *Southwest Natural Gas*, discussed in text accompanying note 103 *supra*, in which the new requirements were less than 20 percent of the old, and states that a complete lack of requirements could be permissible, while comment 3 reasserts the importance of the proviso. Leading case authority and commentary also supports the view that good faith decreases are permissible regardless of any estimated requirements. See, e.g., *R.A. Weaver & Assoc. v. Asphalt Constr., Inc.*, 587 F.2d 1315, 1321-22 (D.C. Cir. 1978); Weistart, *supra* note 93, at 625-39. Regarding increases, the Code proviso appears to have more of an impact. See, e.g., *Shea-Kaiser-Lockheed-Healy v. Department of Water & Power*, 73 Cal. App. 3d 679, 140 Cal. Rptr. 884 (1977). Second, at least as to increases, the Code proviso may be only codifying the pre-Code law of some states. See J. WHITE & R. SUMMERS, *supra* note 23, at 124-25. Although the language of the increase in requirements decisions suggest that good faith is less

3. *Percentage Leases*

Lessees in commercial leases frequently agree to pay rent based upon a percentage of their gross receipts. Common examples require the lessee to pay a fixed amount or a percentage of receipts, whichever is greater, or to pay a fixed amount plus a percentage of receipts over a stated sum. Such a lease has benefits in allocating the risk of the lessee's venture, but it also exposes the lessor to opportunism. A recurring problem under percentage leases involves the lessee opening a new outlet near the leased store while not expanding, curtailing, or closing the leased store, thereby reducing receipts, and the rent paid, from the level that would exist without the new outlet. Many, although by no means all, decisions have considered whether such lessees act in bad faith, and the courts have had difficulty in determining the appropriate principles for guiding these cases.¹²¹ The question arises whether the implicit good faith term is a low-cost method of policing the opportunism problem that the otherwise desirable percentage lease arrangement causes.

Opportunistic behavior provides a ground upon which to separate good from bad faith. A lessee may open a new outlet to increase profits, with the profits coming from lower costs or increased sales (relative to those attainable with only the first store). If the lease does not permit this action and if the lessee would not have opened the new store but for the reduced rental, the lessee has acted opportunistically and, accordingly, can be said to have acted in bad faith. Under this circumstance, the lessee's act transfers wealth from the landlord to the tenant at the expense of at least the costs of opening up the second store, and at the expense of lessors in future cases who

important than in decrease cases, the results reveal a much closer correlation to the opportunism rationale. See notes 110, 118, 119 *supra*. In addition, of the pre-Code cases that on their facts disapprove an increase, issues such as reliance and intent may explain at least some of their results. See notes 95, 105 *supra* and accompanying text. Third, rigid application of the proviso can lead to anomalous results. For example, in *Shea-Kaiser*, the court imposed a maximum requirement when the actual requirements were greater and when the court admitted that it may have been doing violence to the parties' intention. Even here the opportunism rationale has, perhaps, some relevance for understanding the case since the court was aware of, but treated as irrelevant, a jury finding of buyer stockpiling in calculating a verdict alternative to that on which the court relied. See 73 Cal. App. 3d at 683 n.2, 140 Cal. Rptr. at 886 n.2.

121. See, e.g., Note, *Resolving Disputes Under Percentage Leases*, 51 MINN. L. REV. 1139, 1142-44 (1967); Note, *The Lessee's Obligations Under a Percentage Lease*, 60 NW. U.L. REV. 677, 682-87 (1965). For a discussion of the approach of many of the courts that do use good faith in this area, see notes 123-27 *infra*.

take protective steps. Like buyers in requirements contracts who decrease their purchases, a lessee has an incentive to divert sales to new outlets when its original lease turns out to be a "bad deal," as when the market rental drops after the lease is formed.

Such opportunism is illustrated in *Cissna Loan Co. v. Baron*.¹²² Cissna had sold a department store business to Baron, leasing to Baron the building in which the business was located, with rent based on a percentage formula. Part way through the lease term, Baron leased space on the second floor of an adjoining building, opened a passage through the wall, moved several of the more profitable departments into the new space, and paid rent on only the reduced sales in the original location. Because there appeared to be no "business" justification for the diversion—for example, business had not outgrown the space available—the costs spent in the diversion only transferred wealth at Cissna's expense.¹²³

The possibility of a "business" justification presents increased sales as a motive for such a move, and many courts have recognized that bad faith should not be found where this or some other "sound" business reason supports the diversion.¹²⁴ *Mutual Life Insurance Co. of New York v. Tailored Woman Inc.*¹²⁵ provides a particularly graphic example. Tailored Woman, already having a percentage lease on lower floors in a Fifth Avenue building, rented from the same lessor the fifth floor for a fixed amount. The business on the fifth floor, which was unrelated to that on the lower floors, proved unsuccessful, and Tailored Woman moved its fur business from a floor sub-

122. 149 Wash. 386, 270 P. 1022 (1928).

123. The court did not analyze the problem as one of good faith, but instead argued that Baron promised to pay a percentage based on sales from its business and that Baron operated one, not two, businesses. For case examples consistent with the *Cissna* result, see *Lippman v. Sears Roebuck & Co.*, 44 Cal. 2d 136, 280 P.2d 775 (1955) (lessee moved retail operations a block away after lessor had spent more than \$75,000 to prepare building for lessee's use). For cases dealing with the reliance aspect, see note 127 *infra*; *Seggebruch v. Stosot*, 309 Ill. App. 385, 33 N.E.2d 159 (1941) (lessee opened up a gas station next door to one on leased premises, causing sales on latter to fall from 12,000 to 200 gallons per month); *Slidell Inv. Co. v. City Prod. Corp.*, 202 So. 2d 323 (La. Ct. App. 1967) (lessee moved into a new location across street, evidence indicating that business would have been equally successful in either location); *Goldberg*, 168-05 Corp. v. Levy, 170 Misc. 292, 9 N.Y.S.2d 304 (1938) (complaint alleging that tenant negligently or willfully diverted sales withstood a motion to dismiss).

124. See, e.g., *Stop & Shop, Inc. v. Ganem*, 347 Mass. 697, 200 N.E.2d 248 (1964); *Dickey v. Philadelphia Minit-Man Corp.*, 377 Pa. 549, 105 A.2d 580 (1954).

125. 309 N.Y. 248, 128 N.E.2d 401 (1955), *aff'd*, 283 A.D. 173, 126 N.Y.S.2d 573 (1953).

ject to the percentage rental to the fifth floor. The facts indicated that business boomed on both floors; thus, the removal of the fur department did not reduce the total rent paid.¹²⁶

This increased receipts situation indicates that identification of opportunism may be clear in principle, but can be quite difficult in practice. Comparing the profits from increased sales with the costs of opening the second store requires determining what the lessee's sales would have been if it had stayed in one store, a calculation which might require some knowledge about the demand conditions in the first store's location. A further complication would occur if the second store had lower nonrent costs than the first, thus presenting a nonopportunistic motive for diversion. The important issue is the lessee's motivations—an issue that might be resolved by examining the reasons for the lessee's projections that profits would increase. Yet to the extent it risked a lawsuit, the lessee would have an incentive to make questionable estimates or to act in a self-serving way to conceal opportunism. On the other hand, if courts implied a duty of maximizing rent upon all lessees in percentage leases, problems would arise similar to those that would arise in requirements contracts if buyers were automatically liable for reductions caused by diversions to other sellers. Thus, it is not surprising that courts prefer a more case-by-case approach to this issue. The difficulties of proof could be eased by stopping diversions only in more obvious opportunism cases, leaving lessors to protect themselves through the use of explicit contractual clauses or other methods. Difficulties could also be lessened by focusing the initial analysis on the objectively verifiable fact of whether the lessee's move was to a nearby location. If not, opportunism appears much less likely to have motivated the move.¹²⁷

126. See 283 A.D. at 178, 126 N.Y.S.2d at 577. The court of appeals noted that the landlord proved no loss from lower rent, but found it unnecessary to consider whether the move actually raised the rent. 309 N.Y. at 254, 128 N.E.2d at 403. Again, the result is correct although the court is not focusing explicitly on opportunism.

For other examples of nonopportunistic diversions, see *Food Fair Stores, Inc. v. Blumberg*, 234 Md. 521, 200 A.2d 166 (1964) (lessee-grocery store owner maintained leased premises but opened two new stores and planned a third in the same fast-growing community as part of a normal expansion); *Palm v. Mortgage Investment Co.*, 229 S.W.2d 869 (Tex. Civ. App. 1950) (in last eight months of a six year lease, lessee, having learned from lessor that he would not be allowed to renew lease, opened a second store nearby, causing rent to drop—second store opened because of need to maintain on-going business, not to avoid rent, for which obligation to pay was about to end).

127. As with requirements contracts, other issues are relevant. An important question is whether it can be inferred that the lessee promised to maxi-

4. *Bad Faith Interpretation*

One example of bad faith is when a party seeks substitute performance and, in so doing, argues incorrectly and unreasonably that the contract should be construed not to require compensation to the other party. Resources used both in arranging the substitute and in making the strained interpretation are wasted, and courts have condemned such interpretations.¹²⁸ Of

mize rents in the leased premises or made some other promise by which what would otherwise be a good faith diversion could be condemned. *Cf.* *Gulf State Theatres v. Hayes*, 534 S.W.2d 406 (Tex. Civ. App. 1976) (lessee expressly agreed to maximize rentals; evidence also existed of diversion only to avoid paying percentage). Landlord reliance is one way to infer such a duty. *See* notes 105, 123 *supra*. Nevertheless, some cases have treated the question of implied covenant as the only issue in diversion cases, ignoring bad faith when factors such as a store opening nearby suggest a serious inquiry is necessary into whether the diversion can be justified other than as an attempt to reduce rent. *See, e.g.,* *Percoff v. Solomon*, 259 Ala. 482, 67 So.2d 31 (1953) (new store opened across the street); *Masciotra v. Harlow*, 105 Cal. App. 2d 376, 233 P.2d 586 (1951) (Lessee moved a restaurant to a location 1 1/2 miles away, substituting a less successful one in its place. The court did not discuss whether the new location had more business than the old.); *Bobenal Inv., Inc. v. Giant Super Mkts., Inc.*, 79 Mich. App. 31, 260 N.W.2d 915 (1977) (new store opened near by).

In cases like *Cisna*, *see* text accompanying notes 122-23 *supra*, whether the diversion is condemned due to bad faith or to a promise to maximize rent or to maintain the same type of business will not affect the lessor's recovery. In other cases, however, the theory will make a difference. For example, in *Kretch v. Stark*, 193 N.E.2d 307 (Ohio App. 1962), the lessee rented two adjacent properties for use in selling clothes. The one subject to the lease in question was rented a few months after the first. The lessee wanted to open the wall between them, but the lessor refused. Eventually, the lessee sold clothes only from the location not subject to a percentage rental. Although this shift of all business to one store may have had costs resulting only in a loss to the lessor, the court argued that there was no fraud, the lessee having made an honest mistake in misjudging the lessor's willingness to open the wall, and refused to imply a covenant to continued use of the leased premises. An implied promise by the lessee not to divert in bad faith was not considered. The lessor asked that the percentage rent be based on all sales in both stores. Such an award would have exceeded that made in a bad faith decision, because at the time the disputed lease was signed, the lessee planned to have sales in both stores.

Finally, as with requirements contracts, the possibility that the contract permits diversion for any reason should be explored. *See* note 95 *supra*. One argument for the lessee would be the right to sublease the premises to anyone without the lessor's approval.

128. For examples of strained interpretations, *see* *Henry G. Meigs, Inc. v. Empire Petroleum Co.*, 273 F.2d 424 (7th Cir. 1960) (party argued that a contract, which allowed it to receive \$39,098.05 if a new contract was not negotiated, did not require it to negotiate—the court rejected the interpretation as made in bad faith); *Mortgage Corp. v. Manhattan Sav. Bank*, 71 N.J. Super. 489, 177 A.2d 326 (1962) (the contract called for the bank either to pay fees for servicing the mortgage until principal and interest were paid in full or, upon bank's termination of agreement, to pay the equivalent of four years of fees. The bank refinanced the mortgage, treating the old mortgage as paid in full, thus refusing to pay fees. The court held that since the mortgage corporation would never have agreed to its rights being so easily made valueless, the bank's acts were not a

course, calling the strained interpretation bad faith adds nothing to an argument based upon standard principles of contract interpretation, but what some consider an act of bad faith can be seen as opportunism and can thus be condemned as raising costs.

Another illustration of bad faith interpretation involves conditions of satisfaction. Many contracts condition the obligor's duty upon that party's being satisfied with the performance of the other party or with some other element of the contract. If such a condition encompasses dissatisfaction based upon any reason, the obligor could seek substitute performance whenever the contract terms become unfavorable due to events occurring after the contract was formed. Moreover, the obligor could accept benefits already conferred without paying for them simply by claiming dissatisfaction.

Because it seems likely that obligees would require a re-drafting of conditions of satisfaction if they could be so broadly construed, courts in this situation often recognize the problem explicitly and take two steps to avoid obligor opportunism. First, whenever possible, they require dissatisfaction to be based on a reasonable person standard.¹²⁹ Second, when the contract explicitly allows personal dissatisfaction even if a reasonable person would be satisfied or when it is impossible to apply a reasonable person test, courts require the dissatisfaction to be in good faith. By employing a good faith test, courts seek to ensure that the claim is not based upon dissatisfaction with something other than the quality of the performance rendered.¹³⁰ For example, in *McCartney v. Badovinac*,¹³¹ a Dr. Ragsdale accused Mrs. McCartney of stealing a diamond from his wife. Mr. McCartney hired Badovinac, a detective, to determine the facts "to the satisfaction" of McCartney. The detective presented his proof that Mrs. McCartney indeed was the criminal, demonstrating her guilt "as certain as anything in

valid interpretation of the contract.); *Westhill Exports, Ltd. v. Pope*, 12 N.Y.2d 491, 191 N.E.2d 447 (1963) (*National Enquirer* hired broker to negotiate a contract on its behalf, but later made arrangements elsewhere, denying any obligation to use broker's efforts—court held contract could not reasonably be read as *Enquirer* claimed). See also L. FULLER & M. EISENBERG, *BASIC CONTRACT LAW* 631-32, 637 (3d ed. 1972); Summers, *supra* note 81, at 244-46.

129. See, e.g., 3 A. CORBIN, *supra* note 1, §§ 644-646; *RESTATEMENT (SECOND) OF CONTRACTS* § 254 (Tent. Draft No. 1-7, 1973); Summers, *supra* note 81, at 240-41. For a listing of many of the relevant cases, see Annot., 86 A.L.R.2d 200 (1962).

130. See sources cited in note 129 *supra*.

131. 62 Colo. 76, 160 P. 190 (1916).

human knowledge can be.”¹³² Mr. McCartney claimed dissatisfaction, whereupon the detective successfully sued because of Mr. McCartney’s bad faith. He was not dissatisfied with Badovinac’s performance in determining the facts, but rather with the facts themselves.

5. “Willful” Substantial Performance

The last example of good faith in performance concerns cases in which a party renders only substantial, not complete, performance.¹³³ For example, a construction company may deviate insignificantly from contract specifications.¹³⁴ In such cases, the performing party is still liable for any damages from the incomplete performance. It has been suggested that measuring these damages should depend upon whether the deviation was willful: if so, it was not in “good faith” and damages should be measured by the cost of curing the defect. If the substitution was not deliberate, however, damages should be measured by the diminution in market value.¹³⁵

“Willful” substantial performance does not involve opportunistic behavior. Assuming that damages are calculated by the loss to the non-breaching party, no wealth is transferred at the expense of the non-breacher. Indeed, if the damages are so measured, the breach will occur only if it benefits the breaching party more than the cost of damage it causes. For example, the breaching party may use for a second job the resources necessary to perform fully on the first contract, and thus may receive more from the second job than the damages would be to the non-breaching party of the first contract. The law should then prefer breach (in this case willful substantial performance) because it will benefit the breacher without harming the non-breacher once damages are paid.¹³⁶ Because there would

132. *Id.* at 78, 160 P. at 191 (quoting the trial court, whose findings and result were affirmed).

133. Whether or not failure to perform is substantial depends upon several variables. See RESTATEMENT (SECOND) OF CONTRACTS § 266 (Tent. Draft No. 8, 1973). But see text accompanying notes 136-37 *infra* for a critique of aspects of the *Second Restatement*.

134. An example is *Jacob & Youngs, Inc. v. Kent*, 230 N.Y. 239, 129 N.E. 889 (1921) in which the deviation involved a substitution of materials that did not reduce the market value of the structure.

135. See RESTATEMENT (SECOND) OF CONTRACTS § 231, Comment d, Illustration 6 (Tent. Draft No. 8, 1973). Although the *Second Restatement* section 266, comment f, substitutes “good faith” for the “less precise” term “willful,” in illustration 6 lack of good faith is equated with “deliberateness,” which in this context seems identical to “willful.”

136. The cost of completion damage award will not necessarily prevent re-

be no opportunism in this case, it is not surprising that, although some courts list willfulness as a relevant consideration, there is considerable evidence that willfulness is rarely dispositive in the substantial performance cases. As the leading treatise on contracts details, numerous cases have found that performance was substantial despite the deviation being willful in the sense of its being intentional and deliberate.¹³⁷

Analysis of the five foregoing illustrations has demonstrated that, despite the misuse of good faith in the substantial performance context and the long-standing confusion over distinguishing good from bad faith, opportunism provides a principled basis on which to structure the concept of good faith in performance. Given such a foundation, good faith becomes a useful implicit term to facilitate reliance on simple explicit contract terms, such as those fixing quantity by requirements or rent by percentage of sales. What has appeared to be one of the most ad hoc and contentless concepts in contract and commercial law emerges instead as a doctrine capable of principled application by courts and of beneficial use by contracting parties.¹³⁸

sources from moving to their highest valued use because the breaching party may be able to buy out of the first contract. This extra negotiation is, however, probably an added cost of the higher damage rule.

137. See 3A A. CORBIN, *supra* note 1, § 707; 5 *id.*, *supra* note 1, § 1123. Some courts have even tried to distinguish "willful" from "deliberate," making the cases even more difficult to follow. *Id.* Focusing on willfulness is also inconsistent with the fundamental maxim of contract law that damages are concerned with relief, not compulsion. See Farnsworth, *Legal Remedies for Breach of Contract*, 70 COLUM. L. REV. 1145, 1145-47 (1970). This is not to deny that there is a difficult issue in substantial performance cases in determining the proper measure of damages. The real issue of measuring damages by the drop in market value or by the cost of completion in cases like *Jacob & Youngs, Inc. v. Kent*, 230 N.Y. 239, 129 N.E. 889 (1921), see note 134 *supra*, concerns whether the subjective value of the non-breaching party is identical to the objective market value. If the subjective value of the owner equals the objective market value, then diminution in market value is the correct award. If, however, there is strong reason to believe that there is a subjective value higher than the objective market value, then given the opportunity of the parties to bargain, cost of completion is perhaps the best available method to protect that value.

138. A recent article provides a contrasting analysis of good faith in performance. Burton, *Breach of Contract and the Common Law Duty To Perform in Good Faith*, 94 HARV. L. REV. 369 (1980). To Professor Burton, the problem of good faith arises when one party exercises discretion in performance that controls the other party's potential benefit, a conclusion with which the opportunism analysis concurs. Discretion is exercised in bad faith when forgone opportunities are recaptured. Determining whether an opportunity is forgone depends upon the reasonable expectations of the party dependent upon the exercise of discretion. Like opportunism, the forgone opportunities test makes

C. TENDER OF NON-CONFORMING GOODS

When the seller tenders goods that differ from their contractual description, generally the buyer may either cancel the sale and return the goods to the seller, or obtain damages for the nonconformity and keep the goods for use or resale.¹³⁹ These remedies have different costs. If the buyer cancels the sale, costs include those of returning the goods, the seller's costs of resale and perhaps of correcting the defect, and the buyer's costs of finding a substitute. If the buyer retains the goods, costs include those of correcting the defect or, if the buyer resells the item, those of resale and of obtaining substitute performance.

Cost, however, is not the only distinction between the two remedies. If the buyer has made a bad deal, either because of incorrect valuation of the goods when signing the contract or because the market price has since dropped, the buyer has an incentive to return the goods to the seller. Such return transfers wealth between the parties: the buyer desires to shift to the seller the risk that the buyer had assumed in the price term of the contract, and thus increase the buyer's wealth at the

good faith an implicit contractual term. Moreover, both tests scrutinize the motives behind discretionary acts.

The two tests, however, differ significantly in their focus, operation, and cost. The forgone opportunities test, with its emphasis on reasonable expectations, apparently turns on the factual context surrounding contract formation. Because both parties benefit at the time the contract is formed from an implicit term against opportunism, however, under the opportunism test courts can *assume* that the parties would not have permitted an act whose sole purpose and effect is to transfer wealth. *See* note 19 *supra* and accompanying text. The question under the opportunistic behavior approach, therefore, is not what the facts reveal about party expectations at the time of contracting, but instead whether a subsequent act is considered opportunistic. Analysis of factual circumstances at the time of contract formation is, of course, occasionally relevant to the opportunism test, as when the parties explicitly sanction an otherwise opportunistic act. *See* note 95 *supra* and accompanying text. Nevertheless, because factual contexts will sometimes suggest only a fragmentary picture of expectations, this Article asserts that good faith is more than, indeed cannot in practice only be, a question of the factual circumstances that reveal the parties' expectations. The more general focus of the opportunism test simplifies application of the good faith concept, and hence reduces contracting costs. By contrast, dependence upon discerning reasonable expectations will induce parties to make their expectations clearer at the time of formation, raising costs.

139. Under certain circumstances, the buyer who returns the goods can collect damages. *See* U.C.C. § 2-711. Most of the discussion about tender of non-conforming goods in this part is based on Priest, *supra* note 20. Priest does not label the problem opportunism, however, although it clearly involves opportunism as that term is defined in this Article. *See id.* at 966-68. More important, the point emphasized in this Article is that other than the costs of drafting around cost-raising legal rules, the possibility of opportunism is the prime problem from a cost-minimizing standpoint.

seller's expense. Whether the buyer can engage in this opportunistic behavior depends significantly on contract law. If the law allows the buyer to manipulate the choice of remedy, he or she may try to return otherwise acceptable goods, for example by "inventing" defects or exaggerating immaterial defects. Buyer resources spent in such activities, seller resources spent to counter them, and additional resources used when buyer retention of the goods is less costly, are all wasted.¹⁴⁰

Professor Priest's exhaustive analysis of the U.C.C. decisions dealing with this problem, however, indicates that the case results are consistent with preventing opportunism.¹⁴¹ For example, he reports that the courts have generally limited the buyer's ability to return goods, particularly when the materiality of the defect and the nature of the buyer's behavior increase the likelihood that the buyer was opportunistic.¹⁴²

When opportunistic returns are thus removed, the only difference between the two possible remedies is one of costs. One of the buyer's two possible remedies will have lower costs than the other, depending upon the relative values of the non-conforming goods to the buyer and seller. These relative values depend largely upon the relative costs to the buyer and seller of correcting the nonconformity or of reselling the goods, and upon the value of the defective goods to other buyers. For example, if the buyer values the goods more than other potential buyers would, returning the goods to the seller would produce the costs listed above and would thus be more costly relative to retaining them.¹⁴³ If others value the defective goods more

140. Sellers will have an incentive to seek return of the goods when the price rises and thus can act opportunistically. In the normal "one-shot" transaction, the only breaches that the buyer can commit are not paying at all or paying late. The seller will have difficulty causing such breaches. In cases of ongoing performance on both sides such as on installment contracts, however, the seller may have more chance for manipulating the buyer's performance. Professor Priest found that in installment contracts, courts have indeed policed against apparent seller, as well as buyer, opportunism. See Priest, *supra* note 20, at 982 n.44, appendix at 31-36 (unpublished).

141. See Priest, *supra* note 20, at 981-1000. As Priest acknowledges, Karl Llewellyn, among others, also understood that return of the goods could allow the buyer to gain at the seller's expense. See Llewellyn, *On Warranty of Quality, and Society* (pt. 2), 37 COLUM. L. REV. 341, 389 (1937). Llewellyn also recognizes, as does Priest, that return of the goods could not be eliminated entirely as a possible remedy. See *id.*, at 388. In some instances damages may be inadequate to the buyer relative to the return of the goods remedy, for example, because of the difficulty of calculation. See Priest, *supra* note 20, at 965.

142. This is seen most explicitly in the installment sale cases. See note 140 *supra*.

143. If the costs of correcting the defect are the same for all parties, then the buyer would not choose resale (with its attendant costs) since the value ob-

than the buyer and the buyer's cost of resale is less than the total of the seller's resale cost plus the cost of returning the goods, then buyer retention and resale is the lower cost alternative.

The parties will adopt the cost-minimizing remedy if the only difference is costs, because neither party wants to increase their joint costs. For example, assume that resale is preferred and that the buyer can resell at a cost less than the seller's resale cost plus the costs of returning the goods. Once opportunism is not attractive, parties will have the buyer resell even if contract law allows the buyer the option of returning the product and forces the seller to pay the costs.¹⁴⁴

D. FRANCHISING

As noted earlier,¹⁴⁵ franchisees can "cheat" on quality in ways that are costly to detect and prove. Moreover, clauses specifying elements of quality will often prove expensive to draft in complete detail and certainly to enforce in court, making them an unattractive solution. Accordingly, the search for less costly contractual alternatives is important. One such solution is a clause allowing the franchisor to terminate "at will." If such clauses are enforced, the franchisor can more effectively eliminate cheating because the costs of proving cheating to an external observer, such as a court, would be avoided and the franchisee would know that detection results in swift termination.

The enforceability of these clauses, however, has been attacked on different grounds over the years. Historically, the argument was that, because the franchisor had not been bound to

tained in resale would be less than the buyer would be willing to pay. Further, because the cost of correcting the defect or the diminution in market value, whichever is lower, would be at least an implicit cost of the seller's resale (the seller would have to discount by the cost of correction if it did not correct itself), return to the seller could cause costs that buyer retention avoids.

144. This is another application of the Coase theorem. See note 109 *supra*. It does not follow, however, that all legal rules have equal costs. If the legal rule does not require the parties to choose the cost minimizing alternative, they will bargain to select that alternative unless the costs of the negotiation exceed the benefits of the alternative. Thus, nonoptimal rules will be more costly by requiring additional bargains. Professor Priest found that several U.C.C. provisions in the non-conforming tender area are not optimal as written. See, e.g., Priest, *supra* note 20, at 974-75 (substantial performance test for buyer return of goods not directly related to cost minimization); *id.* at 979 (Code does not compensate seller for buyers' use of goods, including depreciation, between acceptance and revocation of acceptance).

145. See notes 6-9 *supra* and accompanying text.

do anything, the contract lacked consideration. Thus, parties using an "at will" clause could not be assured that their contract was binding. By 1940, however, most courts had recognized that franchise contracts were enforceable even if terminable at will.¹⁴⁶ More recently, under "Franchisee Day in Court Acts" and various contractual doctrines, an attempt has been made to protect franchisees against "arbitrary" termination and even to give them a right to renew their arrangements on "reasonable" terms.¹⁴⁷ The most common ground for advocating this position emphasizes the necessity of reconciling the "disparity in bargaining power" between the franchisor and the franchisee. Indeed, the terminable at will clause is considered evidence of such a disparity. How else could such a one-sided contract be explained? When the problem of franchisee cheating is considered, however, the clause's function becomes understandable. The clause is a lower-cost method than is litigation of reducing the franchisee's incentive to cheat.

146. Compare *Miami Coca-Cola Bottling Co. v. Orange Crush Co.*, 296 F. 693 (5th Cir. 1924) (no consideration) with *Bushwick-Decatur Motors, Inc. v. Ford Motor Co.*, 116 F.2d 675, 676 (2d Cir. 1940) (no consideration theory is not "appropriate" to resolve dispute concerning termination under an "at will" clause). See Gellhorn, *Limitations on Contractual Termination Rights—Franchise Cancellations*, 1967 DUKE L.J. 465, 463-94 (1967); Gilmore, *supra* note 38, at 34 (discussing the similar problem that contract law had with requirement contracts). Although franchisees often used the no consideration argument to refuse to follow terms of the agreement such as accepting certain shipments from the franchisor, franchisors occasionally justified termination by arguing that without consideration there was no contract to begin with and hence the termination could not be challenged. See Note, 28 NW. U.L. REV. (previously ILL. L. REV.) 800, 804-07 (1934).

Under the doctrine of consideration, there were mutual rights, with a franchisor at least promising to give notice of the termination. Not to enforce the clause for "lack" of consideration was in effect to question the adequacy of consideration, something that contract law has long eschewed.

147. See *Texaco, Inc. v. Appleget*, 63 N.J. 411, 307 A.2d 603 (1973). *Contra* *Corenswet, Inc. v. Amana Refrigeration*, 594 F.2d 129 (5th Cir. 1979), *cert. denied*, 444 U.S. 938 (1979). See generally Brown, *Franchising—A Fiduciary Relationship*, 49 TEX. L. REV. 650 (1971); Gellhorn, *supra* note 146.

Judicial interpretations of the U.C.C. concerning whether terminations under "at will" clauses must be made in "good faith" are inconsistent. Compare *Tele-Controls, Inc. v. Ford Indus., Inc.*, 388 F.2d 48 (7th Cir. 1967) (U.C.C. § 1-203, which requires good faith in every contract and which cannot be "disclaimed by agreement," prohibits termination without cause) with *Corenswet, Inc. v. Amana Refrigeration, Inc.*, 594 F.2d 129 (5th Cir. 1979) (given pre-Code Iowa decisions, § 1-203 and § 1-102 will not be interpreted to prevent arbitrary termination under "at will" clause) and *Rockwell Eng'r Co. v. Automatic Timing & Controls Co.*, 559 F.2d 460 (7th Cir. 1977) (in an agency contract of indefinite term, rather than applying § 1-203 and § 1-102, which were not mentioned in the opinion, court applied U.C.C. § 2-309, allowing contracts of indefinite term to be terminated at any time by either party upon reasonable notice, making contract terminable at will regardless of bad faith).

Franchisors and non-cheating franchisees benefit from the resulting reduction both of cheating and of the costs necessary to terminate cheaters.¹⁴⁸

If this were the entire story concerning the terminable at will clause, its unrestricted use would be beneficial; but franchisor opportunistic behavior under the clause must also be considered. Because the franchisee often invests in building and fixtures that may be more useful in the current franchise than in alternative uses, a value exists that the franchisor could appropriate if given the opportunity. Moreover, franchisees often pay fees that are nonrefundable if they are terminated. If the terminable at will clause is interpreted literally, franchisors could terminate solely to capture these values.¹⁴⁹

Important nonlegal checks deter franchisor opportunism. If a franchisor terminates a franchisee without at least some colorable claim of cheating on quality, the incentives of the remaining franchisees to maintain quality will decline and the franchisor will find it more difficult to procure additional qualified franchisees.¹⁵⁰ A franchisor might accept this cost if it is willing to engage in mass turnover from franchise to company-

148. The "at will" clause also avoids a possible court battle when the franchisor desires to terminate an "inept" franchisee, such as one who can not meet reasonable sales quotas. That these benefits of the clause exist does not prohibit scrutiny of the clause for procedural unconscionability: procedural unconscionability does not involve the concept of disparity of bargaining power. *See generally* Epstein, *supra* note 73.

149. For a more detailed discussion of franchisor opportunism upon which this Article draws, see Klein, *supra* note 2, at 359-60. As Klein argues, the existence of this appropriable value also deters franchisee cheating because it increases the loss to the franchisee from being caught. *Id.* at 359.

Contrary to Klein's argument, this analysis of franchising does not undermine the analysis of stipulated damages. *See* notes 158-80 *infra* and accompanying text. Although a penalty clause would deter cheating for the same reason, from the franchisor's standpoint such a clause is relatively inefficient even if penalties are freely enforced because it involves court enforcement to prove cheating that the creation of the appropriable value and the use of the terminable at will clause are designed to avoid. Nor is it a sufficient answer, as other commentators have claimed, that the parties can always protect themselves through contractual clauses. *See* note 177 *infra* and accompanying text.

150. Although this check may exist in the other examples to deter opportunistic behavior, *see* notes 5-8 *supra* and accompanying text (discussing the importance of reputation), the continuous dealing in franchising is of particular importance to the relationship because of the existence of multiple franchisees.

Another complication in the franchise context is that the franchisor may engage in a non-opportunistic termination without any evidence of franchisee cheating. If demand will fall such that some franchisees will be put out of business, those franchisees have an incentive to cheat on quality because neither termination nor a loss of future sales deters them. Accordingly, the franchisor might engage in "preemptive" termination. *See generally* Klein & Leffler, *supra* note 2.

owned outlets, or if it can hide the opportunistic nature of the terminations. The higher costs of a company outlet relative to the costs of franchising, however, may produce net losses from terminating franchisees opportunistically. These higher costs may arise from decreased incentives of employees, compared to those of franchisees who have "a piece of the action," which could result in lower relative productivity of employees. Although the franchisor can increase employee incentives through profit sharing, pension plans, and other such measures, making franchisee and employee incentives equivalent creates the possibility of opportunistic firing of employees. After opportunistically terminating its franchisees, however, the franchisor would have difficulty finding employees willing to subject themselves to possible opportunism.¹⁵¹

Little evidence currently exists that measures the effectiveness of these market incentives in policing franchisor opportunism.¹⁵² Because information is costly and because franchisee termination alone does not prove that a franchisor behaved opportunistically, termination presents a problem of subtle opportunism. Although one cannot conclude *a priori* that actual franchisor opportunism is nonexistent or even infrequent, even if the market checks are assumed to be effective, it does not necessarily follow that the law has no role in deterring franchisor opportunism. Contract law might lower the costs of deterrence. If the phrase "at will" is understood to include opportunistic terminations, then the resulting set of contracts will be optimal. A different understanding of the phrase, however, might lower costs. Contract law might reduce the costs of pro-

151. An unresolved issue concerns why many firms initially use employees rather than franchisees. A partial explanation may be that the legal movement to protect franchisees (including the movement in antitrust law) has made their use less attractive. See generally Klein, *supra* note 2, at 365-67.

152. Klein contends that franchisor opportunistic behavior is rare or even nonexistent, although he states that his conclusion is based only on casual empiricism. See Klein, *supra* note 2, at 360. Of course, to listen to franchisees and franchisors, opportunism by both groups is rampant. See Penn, *Franchisers Are Often on Outs With Outlets, Especially in Fast Food*, Wall St. J., Jan. 2, 1979, at 1, col. 6. For a recent case with evidence of the franchisor attempting opportunistic terminations, see Photovest Corp. v. Fotomat Corp., 606 F.2d 704 (7th Cir.) cert. denied, 445 U.S. 917 (1979) (although it could not terminate "at will," franchisor made more profits from company-owned than franchised stores, and was found to have acted to eliminate franchisees, including coercing them to terminate on terms favorable to franchisor). Cf. Chrysler Corp. v. Quimby, 51 Del. 264, 144 A.2d 123 (1958) (to the benefit of Chrysler, Quimby became sole stockholder of auto retail corporation that was one of Chrysler's franchisees; Chrysler then terminated the franchise, obtaining the benefit of Quimby's action, but destroying its value to Quimby).

protecting franchisees against franchisor opportunism by presuming that the parties have agreed not to engage in opportunistic behavior unless they explicitly state to the contrary. Given that franchisees often lose large investments in property, reputation, and time if the franchise is terminated, they would presumably not lightly expose themselves to this hazard. Thus, nonopportunism may be a reasonable interpretation of "at will" clauses.¹⁵³

Before concluding that judicial adoption of this interpretation could lower costs, one must consider the costs of the judicial system. These costs are likely to be significant, for at least two reasons. First, there is the difficulty of distinguishing between opportunistic and other terminations. Some indirect evidence could be considered, such as: 1) existence of a franchisee investment that can be appropriated, 2) franchisor evidence of a nonopportunistic reason for termination, and 3) mass termination of franchisees. Such evidence, however, appears more ambiguous than, for example, the existence of unanticipated circumstances giving rise to a mutually beneficial reason for a modification. Although the first type of evidence states a prerequisite for franchisor cheating, an inference of opportunism does not follow given the possibility of franchisee cheating and our lack of knowledge about the frequency of either type of cheating. The second type of evidence is important, but uncertainty over judicial interpretation of such evidence is a major reason for the very existence of the "at will" clause. The franchisee can sometimes reasonably dispute the franchisor's evidence and, in any event, claim that opportunism was the "real" reason for the termination.¹⁵⁴ Only the third type of evidence raises a clear, albeit rebuttable, infer-

153. Klein contends that the "at will" clause is understood this way, but that it is also understood that court enforcement of this implied understanding is not allowed. See Klein, *supra* note 2, at 360. In any event, judicial reaction to that clause affects how the parties understand its meaning.

154. For example, the franchisee can claim that the problems existed for many years or also exist with other franchisees, yet were or are being ignored. For a detailed discussion of the arguments that both parties make when an external observer decides the legality of a proposed termination, see S. MACAULEY, *LAW AND THE BALANCE OF POWER* 148-58 (1966). Although Macauley is sympathetic with the movement to protect franchisees, in referring to the Wisconsin statute to protect automobile dealers, he concludes that "[s]ince the manufacturer has no clear line as to what is and is not permitted, the safe course is to do nothing that might be questionable. Unfortunately, this may be inconsistent with demanding the utmost efficiency from dealers and pushing them hard to get it." *Id.* at 156. See *id.* at 162. But see *id.* at 164-88 (arguing that movement to assist dealers contains both costs and benefits).

ence of franchisor expropriation.¹⁵⁵ Judicial intervention could be limited to focus only on this fact, but, without knowing how much franchisor opportunism exists even without mass termination, one cannot be confident that this solution is correct.

This lack of objective information increases the costs of judicial resolution of the termination problem. Further, current judicial performance itself is perhaps even more important in increasing these costs. Although some of the current judicial and legislative movement to protect franchisees is undoubtedly aimed at perceived franchisor opportunism, the focus on bargaining power and on franchisee "rights" to a job indicate a misunderstanding of the underlying problem: both the franchisor and franchisee can act opportunistically. Given this misdirected judicial performance, the unusually powerful nature of the market check against opportunism that is created by the existence of multiple franchisees,¹⁵⁶ and the lack of objective criteria to identify opportunism,¹⁵⁷ the only certain situation for judicial intervention would be in the mass termination case. At the least, however, judicial recognition of the underlying problem should reduce some of the uncertainty and, accordingly, costs in this area of contract law.

E. PENALTY CLAUSES

Contracting parties occasionally stipulate the dollar amount that the breaching party must pay the nonbreacher. Although these clauses are usually enforced and accordingly categorized as liquidated damages, they are sometimes not enforced as penalties. To be deemed a penalty, a necessary though not sufficient condition is that the amount of the clause must overcompensate the injured party for the damages from the breach. A recent article by Professors Clarkson, Miller, and myself suggested that a rational distinction exists between liquidated damages and penalties.¹⁵⁸ Although the term was not then used, the problem that the distinction avoids is opportunistic behavior.

155. For example, one case of mass termination appeared to follow a court interpretation unfavorable to the franchisor and was not an attempt to expropriate. See Klein & McLaughlin, *Resale Price Maintenance, Exclusive Territories and Franchise Termination: The Coors Case* (unpublished working paper 1979).

156. This check is unusually powerful relative to the other examples discussed in this Article.

157. This problem makes it more difficult for even properly focused judicial intervention to be effective.

158. See Clarkson, Miller & Muris, *supra* note 9.

Damage clauses stipulating an amount that exceeds the actual damages create an incentive to engage in opportunistic behavior. With the inclusion of such a clause, a promisee has more to gain from the promisor's breach than from performance, giving the promisee an incentive to expend resources in procuring a breach. These resources, plus those the promisor spends to counter the promisee's efforts, are socially wasted. As with other forms of opportunistic behavior, their only purpose is to transfer wealth. Before the clause can be condemned as opportunistic, however, the promisee must have an opportunity to induce the breach. Because detection of such inducement results in nonenforcement of the clause, parties will use subtle inducement that courts are unable to detect easily. We suggested several possible situations in which such behavior could occur,¹⁵⁹ finding that the case law apparently enforces stipulated damage clauses unless there is both an opportunity and an incentive to induce breach.¹⁶⁰ The effect of the cases therefore adds to stipulated damages clauses an implicit condition that the courts will police enforcement of the clauses against possible opportunistic behavior. Decisions that treat stipulated damage clauses as penalties do not appear to involve clauses designed to overcompensate the nonbreacher, but instead seem usually to involve other circumstances, particularly clauses that were a reasonable estimate of the damages from a set of events that did not occur.¹⁶¹ Thus, when the anticipated events do not occur, parties can ignore the problems of opportunistic behavior because the clause in fact becomes an unenforceable penalty.

Although our policy distinction explains the cases with a high degree of accuracy,¹⁶² some contend that the distinction

159. *Id.* at 368-72. Because a stipulated damage clause is sometimes the only manner in which a party would receive damages, in these cases the parties will be reluctant to solve the problem of opportunistic behavior by not using a clause.

160. *See id.* at 378-90.

161. The sources in Clarkson, Miller & Muris, *supra* note 9, cite directly or indirectly dozens of stipulated damage clauses that were not enforced. Roughly one-fifth of these cases did not provide sufficient facts from which one could rigorously discern the specific nature of the underlying transaction. Cases from this subset, however, almost always involved situations similar to those found in cases which gave sufficient facts; thus, their nature appears accurately reflected in the text accompanying this footnote. By far the most numerous class of "penalties" involved clauses that were not drafted to apply to the facts as they occurred—in particular, cases when, unexpectedly, no damages occurred with the breach. Moreover, a small percentage of decisions cannot be explained by our or any other theory. *See id.* at 351, 378 n.74.

162. *Id.* at 378-90. Particularly telling are cases without either opportunity

between liquidated damages and penalties is unwarranted, ostensibly on three grounds. First, some critics suggest that important groups of beneficial stipulated damage clauses are not enforced.¹⁶³ They charge that liquidated damage clauses cannot presently be used to recover nonprovable damages, particularly when the damages are based on the subjective valuation of the parties. Individuals are thus deterred from entering into contracts without the clause, because normal rules for recovering damages would undercompensate the injured party.¹⁶⁴ Under our analysis, however, if the amount specified by the clause is closely related to the damages likely to be actually suffered, little incentive exists to engage in opportunistic behavior. Accordingly, stipulated damage clauses for this purpose should be enforced. Nonenforcement of these clauses would warrant criticism of the current distinction between liquidated damages and penalties, although not necessarily of our suggested distinction. In fact, however, there is little or no evidence that courts classify as penalties clauses that involve unprovable damages, and other evidence indicates that courts will enforce such clauses.¹⁶⁵

Another type of clause that is considered beneficial yet currently unenforceable is created by a new entrant to an industry who agrees to pay damages upon breach in excess of the amount needed to compensate the nonbreacher.¹⁶⁶ This clause may serve as a substitute for having a reputation for prompt performance, and, being less costly for a new entrant than offering a lower price, it facilitates entry. Although new entrants might offer to stipulate damages for this informational reason,¹⁶⁷ no obvious reasons exist why the amount of the clause need exceed the compensatory level. Consider a construction company debating whether to use a new subcontractor or an existing one. The new subcontractor can offer a stipulated damage clause that will fully compensate the construction company for damages that occur, including damages that would not

or incentive to induce breach, which are freely enforced regardless of whether the amount of the clauses bears a reasonable relationship to the amount of damages. *Id.* at 383-87.

163. See, e.g., Goetz & Scott, *Liquidated Damages, Penalties and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach*, 77 COLUM. L. REV. 554 (1977).

164. See *id.* at 567-68.

165. See Clarkson, Miller & Muris, *supra* note 9, at 379-80.

166. See A. KRONMAN & R. POSNER, *THE ECONOMICS OF CONTRACT LAW* 224 (1979).

167. Clarkson, Miller & Muris, *supra* note 9, at 367-68.

be covered absent any stipulated damage clause, such as uncertain damages, consequential damages, the costs of litigation, and attorneys' fees.¹⁶⁸ All else being equal, the contractor will prefer a contract containing this clause to one without it and will accept the new subcontractor if the benefits of the clause outweigh the costs of the lack of a reputation.

Thus, through a fully-compensatory liquidated damage clause, the new firm can overcome its reputational disadvantage without offering a lower price. The new entrant in effect signals that it will cover all costs of its failure to perform. Because of their reputation, established competitors of the new entrant will presumably accept the same clause only at a higher price than the new entrant. Even if some competitors are willing to sign stipulated damage clauses, the new entrant will still offer two advantages. First, it can make the clause fully-compensatory, for example, by agreeing to pay for consequential damages, attorneys' fees, and other costs of collection. Second, it can reduce the cost of transacting by engaging in minimal negotiation regarding the clause. The new entrant will be at a disadvantage only if established firms offer equivalent clauses at the same price and with the same level of negotiation. In this unlikely case,¹⁶⁹ the new entrant can either raise the amount of the clause or lower the price of performance. Lower prices are the likely alternative in this unusual case. The contractor will prefer a lower price with the fully-compensatory clause to a more-than-compensatory clause at a price reflecting its incremental expected value, unless the contractor wants to engage in speculation about breach. Given that an over-compensatory clause gives the contractor, who already has the opportunity, the incentive to induce breach, the new entrant will probably have some qualms about the risk of breaching. If it has such qualms or if competition forces the new entrant to respond to the desires of its consumers, it will prefer to offer a lower price with a stipulated damage clause

168. For a detailed discussion of the enforceability of reasonable attorneys' fee clauses, see *Equitable Lumber Corp. v. IPA Land Dev. Corp.*, 38 N.Y.2d 516, 344 N.E.2d 391, 381 N.Y.S.2d 459 (1976). See also S. WILLISTON, *supra* note 32, at § 786. As Williston notes, a few states regard most attorneys' fee clauses as necessarily unreasonable. For a recent example, see *Missouri Pac. R.R. v. Winburn Tile Mfg. Co.*, 461 F.2d 984 (8th Cir. 1972) (Arkansas law).

169. The case is unlikely because it appears that most stipulated damage clauses are not fully-compensatory. For example, of the over 40 construction company cases referred to in our earlier Article, see note 9 *supra*, not one was fully-compensatory in the sense used here.

that is fully-compensatory rather than a clause stipulating a higher amount.

Besides lacking a reputation for prompt performance, the new entrant may have the further disadvantage of being perceived as less likely than established firms to pay damages upon breach. An overcompensatory clause will not affect this disadvantage for the individual new entrant.¹⁷⁰ If in fact the new entrant breaches and is judgment-proof, the right to collect an overcompensatory amount will not benefit the injured party. Even if it did, if the risk of nonpayment were substantial the customer of the new entrant could better protect itself by obtaining a bond from the new entrant. For reasons discussed in the preceding paragraph, the bond is unlikely to be for an overcompensatory amount unless the promisee wants to speculate on a breach, probably an empirically trivial occurrence.¹⁷¹

170. Leaving aside as beyond the scope of this Article the question of whether such an arrangement would be enforced in bankruptcy, an over-compensatory clause could benefit the promisee if it allowed the promisee to recover more than he or she otherwise would in a bankruptcy proceeding. But the purpose of the clause in this case would not be to overcompensate the promisee, but to minimize undercompensation. Thus, if a bankruptcy did not occur, the clause could be called a penalty without hindering this purpose.

The chance that some of several promisors for the same project could not pay any damages upon breach raises the possibility of using an over-compensatory clause in each of the contracts to provide ex ante for a compensatory return. To use an extreme example for the sale of illustration, a lender of \$100 to five individuals might require each to pay \$500 (plus interest) upon breach if the lender found all of them as likely to breach and only one as likely to pay damages. See Clarkson Miller & Muris, *supra* note 9, at 364-65. Spread over the five borrowers, the clauses are ex ante compensatory, although over-compensatory as to each contract. As long as the ex ante conditions hold, there is no incentive for opportunism and hence the clauses should be enforced. It would not defeat the usefulness of the over-compensatory clause in these cases, however, if the courts scrutinize these clauses as a class for ex post overcompensation. Indeed, such scrutiny would save potential victims at least some of the expenses of policing against opportunism. I know of no cases discussing this type of clause, and, although our theory would support its use, practical reasons might militate against it, including its infrequent use by contracting parties. See text accompanying notes 178-79 *infra*.

171. Not only would the promisee have to compensate the promisor (the party who would pay under the clause) for the increased risk, but the promisor is also more apt to know the correct likelihood of his or her own breach, making the "bet" a poor one for the promisee. Moreover, the promisor has an important reason to be wary of speculation if the promisee can induce breach in a manner difficult to detect. In short, the promisor will be less likely to gamble when the game is not honest and games on which players are able to bet are less likely to be honest. Finally, parties wanting to speculate can find many other methods of speculation that involve well-defined markets for that activity. If it is empirically trivial, allowing speculation is not worth the costs of opportunistic behavior that would result from enforcing all stipulated damage clauses. When opportunistic behavior is not a problem, and thus the game is "honest,"

A second criticism of the liquidated damages/penalty distinction involves the costs of making it. The argument is that the distinction is not optimal if it increases costs to a level that more than offset the benefits of eliminating opportunistic behavior. The distinction arguably increases litigation expenses and, because of the confusion surrounding it, results in an occasional judicial mistake. The current distinction does not appear, however, to entail significantly higher litigation costs than would the alternative of enforcing all stipulated damage clauses, particularly given the nuances of proposed alternative rules.¹⁷² The adoption of our proposed rationale would reduce confusion over the distinction, thereby reducing related costs. As for benefits, the gains from avoiding opportunistic behavior may not be large. If they indeed are small, then even a moderate increase in litigation costs would make the rule more costly than enforcing all clauses. There are several reasons, however, why the costs of engaging in and protecting against breach in-

our distinction would allow enforcement of even clauses entered into for speculation.

Two other recent observations on penalty clauses are worth noting. First, Schwartz argues that "[l]iquidated damage clauses are not likely to inspire many attempts to induce breach . . . for if the penalty is high, the promisee would have to go to great lengths to get the promisor not to perform." Schwartz, *The Case for Specific Performance*, 89 YALE L.J. 271, 292 n.59 (1979). The point is a good one, and it supports our position. Promisees will guard against inducement; this is costly, even if in equilibrium little inducement actually occurs. Unless promisees could eliminate inducement entirely and promisors thought it fruitless to attempt inducement, two conditions unlikely to occur in a world of positive information costs, penalties still create the problem we discuss.

Second, although not discussing the legal rules for stipulated damage clauses, a recent article implies that a penalty clause would internalize what is now an external benefit, namely free-riding on the efforts of a competitor to find a good contractual match by inducing that match to breach. See generally Diamond & Maskin, *An Equilibrium Analysis of Search and Breach of Contract, I: Steady States*, 10 BELL J. OF ECON. 282 (1979). The law, however, probably already avoids this problem under circumstances in which the authors postulate that it would occur since the "free-rider" will have to pay the non-breaching parties' costs of finding a suitable substitute match. There is also evidence that the externality occurs infrequently, if at all. See Landes & Posner, *Joint and Multiple Tortfeasors: An Economic Analysis*, 9 J. LEGAL STUD. 517, 552-55 (1980).

172. See Clarkson, Miller & Muris, *supra* note 9, at 376-77. Relative to a rule enforcing all clauses, the current distinction avoids the costs of renegotiating and of identifying and drafting around exogenous events that might require payment of stipulated damages. Litigation costs might not significantly decrease (or even decrease at all) under the proposals to eliminate the distinction because those proposals would allow other legal challenges to the clause. Moreover, understanding of the distinction that has been articulated here would, if accepted, reduce the costs of litigation.

ducement would not be trivial.¹⁷³ Although the issue can only be resolved empirically, we concluded on balance that the benefits of not enforcing penalty clauses—namely, avoiding opportunistic behavior—appear to exceed the costs. In the absence of better empirical evidence, these costs appear to include only forgoing the benefits of a few clauses designed to be overcompensatory,¹⁷⁴ and perhaps some increased litigation expenses.

A final criticism that might be asserted is that the liquidated damage/penalty distinction is based upon paternalism when no basis for paternalism exists. Kronman and Posner argue that if parties agree to a stipulated damages clause when induced breach is possible, they will have considered this danger in negotiating the terms of the contract.¹⁷⁵ If the contract then is formed, benefits presumably exceed costs, including the potential costs of the opportunistic behavior. They thus argue that, however expensive those costs may be, if the contracting parties bear all costs, how can the result be questioned?

The answer is at least two-fold. First, reducing the costs of opportunism would release resources for other uses by lowering the costs of exchange. Second, although it is true that many parties would form contracts after weighing the costs of opportunistic behavior, at the margin the added costs of opportunistic behavior would deter some bargains that would otherwise be made. Some parties might choose alternatives such as vertical integration that are more costly than contracting would be if the law deterred opportunism. Thus, eliminating opportunistic behavior not only lowers the costs of contracts that are consummated, but also allows more exchanges to be made. Put in more general economic terms: given existing constraints, the resulting contractual arrangements will be optimal. Changes in

173. *Id.* at 368-72. The numerous examples of cases involving prevention show that parties at least occasionally engage in opportunistic behavior of the breach inducement variety. See notes 83-92 *supra* and accompanying text. Before prevention was a well recognized doctrine, parties apparently openly engaged in breach-inducement to obtain the benefits of stipulated damage clauses. A well-known and graphic example is an early English case, *Blandford v. Andrews*, 78 Eng. Rep. 930 (Q.B. 1599). In *Andrews*, the defendant had undertaken to procure a marriage between the plaintiff and one Bridgette Palmer; upon failure to procure the marriage the plaintiff was to receive £80. When the plaintiff sued for the £80, defendant argued that the plaintiff had gone to Bridgette, called her a whore, and warned that she would be tied to a post if he married her. The plaintiff won, apparently because the defendant did not engage in a maximum effort to convince Bridgette nevertheless to proceed with the marriage.

174. Clauses entered into for speculation are one example of such overcompensatory clauses. See note 171 *supra*.

175. See A. KRONMAN & R. POSNER, *supra* note 166, at 224-25.

constraints, however, typically result in a different optimal set of arrangements. Measured by their transaction costs, one set may be preferable to the other. In short, that the parties choose to stipulate damages under one set of constraints does not preclude the relative efficiency of a different set of constraints: namely, one in which not all such clauses are enforced.¹⁷⁶

Kronman and Posner also imply that parties could avoid the problem of induced breach simply by including clauses specifically preventing opportunism. Listing all types of induced breach, however, would raise the costs of the contract. Although the parties could agree to a more general clause against penalties when an induced breach could occur, a court would probably have difficulty interpreting such a clause. Because the parties would then need to agree to a general definition or to the precise circumstances that the term covers, such agreements would require costly negotiation. Moreover, even if such additional agreement over the term's meaning were unnecessary, the term would be more costly than an implicit term because it would force the parties to bargain over it. Indeed, the argument that parties can always draft a clause to avoid potential problems proves too much because it can apply to any doctrine of contract law that is claimed to reduce transaction costs. It is always more costly for contract law to adopt rules that force additional negotiations. At some stage the law would contain so many cost-increasing principles that costs of correcting the law through contract would deter some exchanges.¹⁷⁷

Nevertheless, the paternalism argument may have force for another reason. Although "penalties" in current cases do not appear to involve planned and intended overcompensation as of the time of the contract, our analysis necessarily implies only that an implicit term limiting the problems of opportunism is desirable. The law, however, takes the additional step of prohibiting parties from drafting around the distinction between liquidated damages and penalties. There is no reason in theory to prevent contracting around the distinction, but there are practical problems. For one, it is not sufficient simply to enforce all stipulated damage clauses, because this increases the costs of stipulated damage clauses when opportunism is a po-

176. See generally Dahlman, *The Problem of Externality*, 22 J.L. & ECON. 141, 150-56 (1979).

177. See A. KRONMAN & R. POSNER, *supra* note 131, at 225. See also the discussion of this issue in Clarkson, Miller & Muris, *supra* note 9, at 371 n.61.

tential problem without producing compensating benefits.¹⁷⁸ Alternatively, parties could state whether they wished the normal liquidated damage/penalty distinction to apply. It is not surprising that this alternative has not been adopted, however, given that contracts have termed the clause a "penalty" when the parties have intended the clause to be compensatory, that the distinction between liquidated damages and penalties has caused confusion, and that few justifications exist for parties to ignore the current rule.

A third alternative would be to separate the classes of cases in which a penalty was mutually beneficial at the time the contract was formed from those in which it was not, and to enforce only the mutually beneficial ones. If the new entrant problem were significant, for example, this would be a viable legal solution. In fact, if a penalty is defined as a noncompensatory stipulated damage clause—a definition that is close to one used in the reasoning if not always in the results of many cases—this alternative has been used to some extent, the best examples being those cases involving limits on damages. Although not compensatory, such limits have many beneficial uses, create no incentive for opportunistic behavior,¹⁷⁹ and have been freely enforced by courts.¹⁸⁰

In any event, failure to allow penalties may well be insignificant. If few cases exist in which individuals desire to contract around the current law, then the costs of "paternalism" appear small. Some beneficial contracts might still be denied enforcement, for example when one party desires to speculate on breach or when the courts mistakenly apply the law. Despite these costs, the benefits of deterring opportunism provide support for the law's current position.

178. This is discussed at length in Clarkson, Miller & Muris, *supra* note 9, at 366-78. The statement assumes that the three objections raised earlier in this part are invalid.

179. *Id.* at 367-69.

180. *Id.* at 384. Arbitration could be another device for drafting around the distinction, although the courts are split upon enforcement of penalties in arbitration. Compare *Associated Gen. Contractors v. Savin Bros.*, 36 N.Y.2d 957, 335 N.E.2d 859, 373 N.Y.S.2d 555 (1975) (penalty enforced because policy against penalties is not sufficient to outweigh policy favoring arbitration) with *Garrity v. Lyle Stuart, Inc.*, 40 N.Y.2d 354, 353 N.E.2d 793, 386 N.Y.S.2d 831 (1976) (under no circumstances can an arbitrator award punitive damages). See also Note, *Punitive Damages in Arbitration: The Search for a Workable Rule*, 63 CORNELL L. REV. 272 (1978).

IV. CONCLUSION

When parties contract, the terms they choose may expose one or both of them to opportunism. To avoid becoming victims, they will expend resources. This Article has analyzed the role of contract and commercial law in minimizing these expenditures and has reached three conclusions. First, when viewed as responses to opportunism, many aspects of the law previously regarded as diverse in nature should be recognized as containing a common unifying principle. Second, courts should employ the opportunism principle within particular doctrines of the law, thereby providing more coherence to these rules than is now thought to exist. Recognition that deterring opportunism provides a basis for the doctrines discussed here, and perhaps for many others as well,¹⁸¹ reduces the confusion

181. This Article does not attempt to analyze, or even to list, all aspects of contract law in which opportunism may be possible in the underlying transaction. In particular, many forfeitures may occur at the inducement of the party receiving the benefit of the forfeiture, *see, e.g.*, discussion of the penalties at notes 158-80 *supra* and accompanying text. Restitution is one principle often used to police forfeiture; deterring opportunism may be relevant to the principles of restitution. A specific, and well known, example in which a court used restitution to avoid a forfeiture is *Britton v. Turner*, 6 N.H. 481 (1834). In *Turner*, an employee with a one year contract left work two and one-half months before the end of the term. The court awarded salary for the work performed on a quasi-contractual theory. Given the possibility of employers inducing breach near the end of the employment term, and thereby attempting to obtain the benefits of the work to that time without paying for them, opportunism can be relevant to understanding the transaction.

Another doctrine of contract law that can deter opportunism is specific performance. One function of specific performance is to provide a remedy in situations in which a breach would occur without the threat of legal consequences. In this sense, specific performance deters opportunism just as does making promises legally enforceable. *See* note 19 *supra*.

At least three sections of Article 2 of the U.C.C. that we have yet to discuss can also prevent opportunism. Under U.C.C. § 2-609, each party to a sales contract has a duty not to impair the other's expectation of receiving performance. When a party has reasonable grounds for being insecure, it can suspend its performance, demand adequate assurances of performance, and, if assurances are inadequate, declare an anticipatory breach. A party can act opportunistically by unreasonably declaring the assurances inadequate, and thus take advantage of a shift in market price in its favor. As do at least some common law courts, the U.C.C. appears to police this possibility with a good faith requirement. *See Summers, supra* note 81, at 248-49. Second, under U.C.C. § 2-311(1), a contract can leave the particulars of performance to be specified by one of the parties. This raises the possibility of opportunism, to which the Code provides that specifications must be in good faith and within limits set by commercial reasonableness. Third, U.C.C. § 2-207 repeals the common-law "mirror-image" rule of offer and acceptance that allowed a party to declare a contract not binding when months after it had been negotiated a price shift made the contract unfavorable. *See, e.g., Poel v. Brunswick-Balke-Collender Co.*, 216 N.Y. 310, 110 N.E. 619 (1915).

Finally, dispute settlement, a topic similar to contractual modification,

and uncertainty that permeate many areas of contract law.

Finally, and more tentatively, the discussion suggests that judges have in fact formulated principles to reduce the cost of opportunism. This conclusion is tentative because empirical evidence is inadequate; the contention that the legal principles analyzed actually lower transaction costs rests in part upon intuitive estimates of the costs involved. Empirical evidence might modify some of the conclusions. Moreover, in some of the areas discussed, the range of judicial opinion encompasses thousands of cases and has not been fully analyzed. As a result, the nuances of some areas (good faith, for example) were not considered; in other areas, such as nonconforming tenders, secondary sources helped form the basis for the conclusion that many decisions effectively lower costs. Even with these qualifications, the analysis presented in this Article provides strong evidence that judges can, and often do, act to lower important costs of transacting.

raises the possibility of opportunism. Courts police settlements for honesty in the belief of the dispute, and thus may deter opportunism. *See* note 29 *supra*.